# FOREIGN GOVERNMENT INVESTMENT IN THE U.S. ECONOMY AND FINANCIAL SECTOR

## JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE, AND TECHNOLOGY

AND THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

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## WITNESSES

Wednesday, March 5, 2008



## APPENDIX

# FOREIGN GOVERNMENT INVESTMENT IN THE U.S. ECONOMY AND FINANCIAL SECTOR

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**Wednesday, March 5, 2008**

U.S. House of Representatives,
Subcommittee on Domestic and
International Monetary Policy,
Trade, and Technology, and
Subcommittee on Capital Markets,
Insurance, and Government
Sponsored Enterprises,
Committee on Financial Services,
*Washington, D.C.*

The subcommittees met, pursuant to notice, at 2:47 p.m., in room 2128, Rayburn House Office Building, Hon. Luis V. Gutierrez [chairman of the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology Subcommittee] presiding.

Members present: Representatives Kanjorski, Maloney, Gutierrez, Meeks, Capuano, Scott, Hodes, Perlmutter; Pryce, Royce, Paul, Manzullo, Jones, Shays, Roskam, McCotter, and Heller.

Ex officio: Representatives Frank and Bachus.

Also present: Representative Moran.

Chairman Gutierrez. This joint hearing of the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

The subject of today's hearing is foreign government investment in the U.S. economy and financial sector.

First, I wanted to say good afternoon and thank you to all the witnesses for agreeing to appear before our subcommittees.

Our first panel includes the Federal regulators with primary jurisdiction over this complex subject matter and our second panel includes two sovereign wealth funds and a foreign pension fund. I should note that this is the first time these kinds of funds have testified before a congressional committee.

We will be limiting opening statements to the chairs and ranking members of the two subcommittees. Without objection, all members' opening statements will be made a part of the record.

At this point, I also want to give general leave if there are other statements from any interested parties that Members would like to enter into the record, without objection, that will be granted.

I yield myself 5 minutes.

Too often these days when most Americans, Members of Congress included, hear the term “sovereign wealth fund” or “foreign investment,” they are likely to conjure images of unfriendly foreign governments attempting to take control of U.S. companies. This vision is easily propagated through one-sided media reports, and in some cases, overreaction by many, including Members of Congress.

We tend to focus our attention on more controversial deals, such as the defunct 2005 Dubai Ports’ deal or the China National Offshore Oil Corporation’s attempt to acquire Unocal.

We do not hear much about the run-of-the-mill, relatively small dollar sovereign fund investment in companies like Motorola and Home Depot that take place on a daily basis and provide much-needed capital for the American economy.

In 2007, foreign investors invested $414 billion into purchasing stakes in U.S. companies, a 90 percent increase over 2006, which represented one-fourth of all the announced deals for 2007.

Where would our economy be right now without these deals? Where would our economy go if these investments were taken away?

As we know, the subprime mortgage crisis has caused a significant strain on U.S. financial institutions, and it has led a number of large banks to seek injections of foreign capital.

In November of 2007, the Abu Dhabi Investment Authority announced a $7.5 billion investment in Citigroup, and in December of last year, Temasek announced a $4.4 billion investment in Merrill Lynch.

These are the kinds of high profile investments that raise questions, especially when we see several of them occurring over a couple of months, and our questions become more punctuated by the many misconceptions about foreign wealth funds, what they are, what they do, and how they are monitored.

Our primary goal today is to answer these questions, to educate members, and to begin a factual substantive dialogue on the issues surrounding foreign investment in the United States and sovereign wealth funds in particular.

For these purposes, I think we have two outstanding panels and an opportunity to learn from some of the best players in international investment. I look forward to a vigorous discussion.

I will now recognize the ranking member of the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Mr. Paul, for 5 minutes.

Dr. PAUL. Thank you, Mr. Chairman. Mr. Chairman, many Americans have expressed concern over the growing role played by sovereign wealth funds in the U.S. economy. Such fears are to a large extent misplaced, as we should be more concerned with the underlying causes that have allowed sovereign wealth funds to accumulate as much capital as they have.

The two major types of sovereign wealth funds are those which are funded by proceeds from natural resources sales and those funded by accumulation of foreign exchange.

The former category includes sovereign wealth funds in Saudi Arabia, Kuwait, and the UAE. Flush with dollars due to the high price of oil, they are looking for opportunities to make that money

work for them. The high price of oil is due in large part to our inflationary monetary policy.

We have literally exported inflation across the globe, spurring malinvestment and a subsequent commodities boom.

The second major category of sovereign wealth funds includes China's sovereign wealth fund, which has the potential to draw on China's more than $1 trillion in foreign exchange reserves. Because of China's current account surplus, it continues to accumulate foreign exchange. Much of this is due to the United States' persistent current account deficit.

Inflationary monetary policy and a desire to stimulate the economy at all costs has led us to become the world's largest debtor, and this debt must be eventually repaid.

The current account deficit has come about because our economy does not produce enough capital goods to satisfy the wants of our foreign creditors. Tired of holding increasingly worthless dollars, it is only natural that our creditors would want to purchase tangibles, which in the present case are stakes in American companies.

Rather than bemoaning the fact that foreign governments are using their dollars to purchase stakes in American companies, we should welcome the stability that such investment is bringing to our economy.

While I am as reluctant as anyone in this room to involve any government in any sort of intervention in the market, the fact remains that without injections of capital from foreign wealth funds, the results of the subprime crisis would have been far worse for many financial firms.

Even now we read that Citicorp, despite the massive funding it has received from sovereign wealth funds, is in danger of collapse until it receives additional funding.

I have always been a staunch advocate of abandoning our loose monetary policy and facing the consequences now, rather than continuing easy money in the hopes of never having to face a recession.

Now that it is clear that decades of Federal Reserve monetary manipulation have led to a severe recession, the thought of sovereign wealth funds investing in the financial sector holds far more appeal than that of a complete collapse of major industry players which would cause catastrophic effects throughout the economy.

Sovereign wealth funds are a necessary consequence of fiscal and monetary policies which have left us overextended. Actions to stifle the operations of sovereign wealth funds and corresponding retaliatory actions by foreign countries could have the same detrimental effect on the economy as the trade wars begun after the passage of the Smoot-Hawley Tariff Act of 1930.

Rather than take actions to limit or prohibit the actions of sovereign wealth funds, I would urge my colleagues to take action to end our inflationary monetary policy.

I yield back.

Chairman GUTIERREZ. I now recognize, for 5 minutes, the chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Chairman Kanjorski.

Chairman KANJORSKI. Mr. Chairman, good afternoon. We meet today at this joint hearing to learn more about foreign government investment in the United States. We will in particular focus on the tremendous growth of foreign wealth funds' investment in our economy.

This hearing also represents the first time that sovereign wealth funds have appeared before a congressional committee. Sovereign wealth funds currently maintain anywhere from $2- to $3.2 trillion in assets globally.

By 2015, some estimate that this figure will reach $12- to $15 trillion. Since 2005, 12 sovereign wealth funds have been created and approximately 40 such funds exist today.

Over the last 11 months, sovereign wealth funds have additionally invested more than $69 billion in U.S. financial institutions. Because these funds are growing so rapidly, both in number and in size, today's hearing comes not a moment too soon.

Currency reserves and profits from commodities are the two primary sources of revenue for foreign wealth funds. The trade imbalances we have created, particularly with China, all but guarantee that the growth of these funds will continue. Couple that reality with the record high price of oil and the picture becomes even clearer; continued foreign investment in the U.S. economy is here for some time to come.

As we begin, I want to welcome our panelists who represent foreign government investors, including funds from Norway and Singapore, as well as Canada's Pension Board.

We are pleased that you have stepped forward. Today, we can begin a dialogue with you and hopefully other sovereign wealth funds will step forward in the future to do the same.

As we proceed today, everyone should understand how our actions have contributed to the growth of sovereign wealth fund investment in the United States. We created the huge trade imbalances that bolster other governments' currency reserves and enable them to invest in our economy.

Similarly, our dependence on foreign oil and our resistance to adopting a sustainable energy policy has made other governments rich with our dollars and allowed them to purchase shares in our companies.

Finally, our national savings rate has been negative in recent years. Although we created these market conditions, we must now take an active role in seeing to it that foreign governments invest with a fair degree of transparency, predictability, and good governance, and do so with an eye toward promoting economic interest as opposed to strategic or political goals.

Without question, we now live in a global economy, but the national security and the national interest of the United States must always remain paramount. Governments generally act in their own best interest. In considering our best interest, we cannot afford to assume that all foreign governments are merely rational economic actors seeking to maximize profits.

This principle may be true in many or even most cases. Governments have strategic interests, too. It is a geopolitical reality. The question becomes: Are they really acting on those strategic interests when investing in American companies?

Merely asking questions here today does not make one a protectionist or an alarmist. Seeking to understand the operations of sovereign wealth funds does not make us fearful of or hostile to foreign governments.

We are not overreacting by conducting this hearing, as some might want to suggest. Rather, we are opening an important conversation and fulfilling our constitutional duty to regulate foreign commerce.

Ultimately, we may decide that developments in this sector warrant the adoption of new laws or regulations. I want all of the witnesses to know that I have an open mind on these matters. Your comments today will help us to determine the best course of action going forward.

In closing, I look forward to hearing the panelists' thoughts on these matters. I want to thank each of you for appearing. Your views will help us to understand where we are and where we are going. We must find a way to promote efficient and viable capital markets in a global world while safeguarding American sovereignty.

Thank you, Mr. Chairman.

Chairman GUTIERREZ. You are welcome, and thank you.

We will now recognize for 5 minutes Congressman Royce, representing Subcommittee Chairwoman Pryce.

Mr. ROYCE. Thank you. I will be very short, Mr. Chairman, but I appreciate your holding this hearing.

We have all seen the media coverage of the recent infusions of cash into some of our struggling financial institutions. Citigroup, UBS, Morgan Stanley, and Merrill Lynch have all been on the receiving end of much-needed support from sovereign wealth funds, and this has been over the last 6 months.

I think it is worth noting the impact that these investments have had on these cash strapped financial institutions during this tumultuous period in our capital markets.

This afternoon's oversight hearing gives us an opportunity to explore the issue further. I welcome that opportunity.

Considering the attention garnered by these funds, I believe it would be beneficial for all parties if these funds consider the adoption of the best practice standards currently being devised by the IMF, and I would like to commend Mr. Skancke and Norway's willingness to openly operate their Fund in a transparent and publicly accountable manner.

However, I would caution against legislative proposals which may lead us down the road towards investment protectionism. I believe such a move has the potential to hinder U.S. economic growth and could hinder job creation in this country.

It is critical that we convey a consistent message of openness to foreign investment. Additionally, we presently have a system in place to investigate potential national security threats resulting from foreign investment transactions. CFIUS allows us to fully scrutinize these deals without unnecessarily limiting the benefits of an open society.

In a global economy, capital will and should flow freely. Unnecessary constraints on foreign capital will only serve to increase the

cost of existing capital and may in fact discourage future foreign investment in our economy throughout the years ahead.

I again thank you, Chairman Gutierrez and Chairman Kanjorski, and I look forward to hearing from our two panels of witnesses.

Chairman GUTIERREZ. Thank you very much. We will now yield 5 minutes to Full Committee Chairman Barney Frank.

The CHAIRMAN. Thank you, Mr. Chairman. I am very pleased we are having this joint subcommittee hearing on this important issue.

I have been asked from time to time what I think about sovereign wealth funds. To some extent, that is like asking me what I think about countries. Some I like a lot, some not so much. The fact is that sovereign wealth funds are reflections of their countries; some are fine and some make me nervous.

Let me begin by expressing some agreement with the gentleman from Texas on the issue that the reason we are here is primarily problems in the American economy. We would differ about what caused them. We are here because of problems in the American economy because decisions made in America, particularly in the financial community, created needs that sovereign wealth funds have filled.

The best defense against sovereign wealth funds having undue influence is for American financial companies not to screw up, so they do not need the money.

Given that they need the money, I am glad that it came. We would be worse off if there had not been those injections of funds.

Having said that, that does not mean there are not reasons for us to be careful. Again, it varies. There are different countries with different motives.

On the whole, the evidence has been that people have invested to try to make money. One of the things we need to avoid doing is making the assumption that when foreigners invest, they are all-wise, all-knowing, and are going to outfox us.

The last time we had this round of concern over foreign investment was when the Japanese, about 20 years ago, decided to go and buy trophy properties in the United States and it became the best foreign aid for the United States that we had in a very long time. They bought Rockefeller Center, Pebble Beach, and a whole range of other properties, and paid way too much for them. That was a mistake.

Of course, the most recent current example is the brilliant move by the Chinese in buying into Blackstone at exactly the wrong moment. We should not assume that these clever foreigners are always going to outfox us.

It is clearly something we want to look at. I do have one suggestion and one other point, which is that I think this committee can take credit on a bipartisan basis, because this is a bill that passed the House under the Republican leadership of the committee 2 years ago, passed it again in a bipartisan way, and that is the establishment on a statutory basis of the Committee on Foreign Investment in the United States. It has already proven its worth in the 3M case.

We are often told, oh, you guys always come in after the fact. Here, the Congress anticipated the problem. We reacted because we did not want to see the Dubai Ports' thing be a signal that we

did not want money. We did not want it to have that negative effect.

We put through legislation which I think works very well and has worked very well.

I do have one proposal that has to be considered. There has been some confusion. I got it wrong myself, about this 10 percent figure. There are people who think the CFIUS statute sets 10 percent as the trigger. As I have since been reminded by staff that I was misremembering this bill that I sponsored, the 10 percent number is not in the bill; 10 percent is in the regulations, and even there, not as a hard and fast figure, but as an indicator.

Given that, however, I think we need to clarify it. As my colleague from Virginia who has been working on this points out, people get suspicious with 9.9 and 9.8 percent. In fact, the way the law is written and even the way the regulations are written, that does not get you out from under, but perception is a big part of this. I think we need to clarify that in the regulations, and one of the things we have to consider is should we be more explicit that if it is a government owned purchase, if it is a government purchase, will that automatically trigger a higher degree of scrutiny?

I think that is not going to be rejectionist, but it does seem to me that would reassure people that yes, we do understand the difference between a country buying this and a purely private set of investors. It does not mean that one is always allowed and one is always prohibited. I think we should be explicit, rather than the 10 percent, and if you do that, maybe it is "X" percent lower for the private sector people.

With those things, I think we can go forward and do it.

My friend from Virginia is here. We have talked about this. He has formed this taskforce. We have designated a member to stand there, and I do not think he will be offended. We did get some questions. What is this taskforce, and what is happening, and are you people going to sort of fracture this?

Jurisdiction over this issue remains fully with this committee. We have a cooperative relationship with the gentleman from Virginia. I welcome his input and the other members. This does not mean that we are going to be dealing with this in a split-up fashion.

We will continue to do this in a reasonable way. I do urge, however, that with regard to that 10 percent, we do some clarification and we make it clear that it is not as firm as people think it is, and particularly, that you do not avoid scrutiny by going slightly under 10 percent, and also that we make it clear as we look at it, the fact that it is owned by a government is reason to be more skeptical at the outset or at least to take more of a look than if it was owned by a purely private entity.

Thank you, Mr. Chairman.

Chairman GUTIERREZ. Thank you, Mr. Chairman. Given those very kind, generous, and warm remarks about the taskforce headed by Congressman Moran, I ask unanimous consent that Congressman Moran be permitted to participate in today's hearing. Hearing no objection, it is so ordered.

First, on our panel is Mr. David McCormick. Mr. McCormick is the Under Secretary for International Affairs at the U.S. Department of the Treasury.

Next, we have Mr. Ethiopis Tafara. Mr. Tafara is the Director of the Office of International Affairs at the Securities and Exchange Commission.

And finally, we have Mr. Scott Alvarez. Mr. Alvarez is General Counsel at the Federal Reserve Board.

Welcome to you all. Mr. McCormick, you may proceed.

**STATEMENT OF DAVID H. McCORMICK, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY**

Mr. McCORMICK. Thank you, Chairman Gutierrez, Chairman Kanjorski, Ranking Member Paul, and Congressman Royce, and also Chairman Frank. It is great to be here today. Thank you for the invitation.

I very much appreciate the opportunity to be able to speak to this committee about sovereign wealth funds. At Treasury, we have been focused on this issue for more than a year now. I am pleased to be able to share some of our views with this committee.

While the term "sovereign wealth fund" was coined a few years ago, the funds it describes are not new. Sovereign wealth funds have existed in various forms for decades, in places as diverse as the Central Pacific, Southeast Asia, Europe, and the Persian Gulf.

At the turn of the century, just 8 years ago, there were about 20 sovereign wealth funds with worldwide assets in the area of several hundred billion dollars.

Since that time, there has been a rapid increase in both the number and the size of sovereign wealth funds. This has been fueled by high commodity prices and the rapid accumulation of official reserves, and 20 new funds have been created since 2000, more than half of those, as mentioned, since 2005. Today, there are nearly 40 funds with total assets between $2- and $3 trillion.

In contrast to traditional reserves, which are typically invested for liquidity and safety, sovereign wealth funds seek a higher rate of return and are invested in a wider range of assets. They emphasize expected returns over liquidity and can take the form of stakes in U.S. companies as has been witnessed in recent months.

Sovereign wealth fund assets are currently fairly concentrated. By some market estimates, only a handful of funds account for the majority of total sovereign wealth assets, and roughly two-thirds of sovereign wealth fund assets are commodity fund assets, as was mentioned earlier, while the remaining one-third are non-commodity funds transferred from official reserves.

While sovereign wealth fund assets may be small relative to the $190 trillion of stock in global financial assets, with roughly $62 million held by private institutional investors, they are larger than the total assets under management in hedge funds or private equity funds. They are growing at a much faster rate.

The rise of sovereign wealth funds clearly has implications for the international financial system. They bring both benefits as well as some potential concerns.

As the President reaffirmed in his May 10, 2007, statement on open economies, the United States is committed to open investment and advancing open markets at home and abroad.

The U.S. economy benefits enormously from open investment, including the investment from sovereign wealth funds. Those benefits come in the forms of jobs, R&D spending, and higher wages.

Over 5 million Americans, 4.6 percent of the private sector, are directly employed by foreign owned firms with U.S. operations. These 5 million jobs pay 25 percent higher compensation on average than U.S. firms and another roughly 5 million jobs are indirectly supported by this foreign investment.

Foreign firms contributed about 6 percent of U.S. output, and 14 percent of U.S. R&D spending in 2006, and in that same year, foreign owned firms reinvested over half of their income, that is $71 billion, back into the U.S. economy.

The case for open investment is strong.

Sovereign wealth funds are an important part of this investment flow. The United States can continue to benefit from sovereign wealth funds to the extent that this investment is economically and not politically driven.

As many observers have pointed out, sovereign wealth funds have the potential to promote financial stability and they generally, over that 50-year period, have had a track record of stable long-term investment and they provided significant capital to the system.

Their long-term investment horizon should enable them to maintain their strategic asset allocations in periods of short-term volatility.

None of this is meant to say that there are not some potential issues to consider. Sovereign wealth funds represent large concentrated and sometimes non-transparent positions in financial markets, with the potential to actually move markets. Actual or perceived shifts in their asset allocations could cause market volatility.

There are two specific sets of issues to consider. First, as is the case with other types of foreign investment in U.S. companies, a small number of sovereign wealth investments in U.S. companies may raise legitimate national security concerns.

Second, sovereign wealth funds raise a number of non-national security related issues about the larger role of foreign governments in markets.

For example, through the inefficient allocation of capital, the perceived unfair competition with private firms, or the pursuit of strategic over return oriented investments, sovereign wealth funds could potentially distort markets.

These investment policy concerns also have the potential to provoke protectionist responses from recipient governments.

It is my view that this protectionist sentiment stems partly from a lack of information and understanding about sovereign wealth funds, which is partly due to the lack of transparency and clear communication on the part of the Funds themselves.

Clearly, better information sharing and understanding on both sides of the investment relationship is therefore needed.

Chairman GUTIERREZ. Will the gentleman please wrap up? Your 5 minutes have expired.

Mr. MCCORMICK. Yes, I will. Thank you.

Let me just say briefly, there are a number of policy responses to this issue. One is the implementation of the law, the CFIUS law, that the chairman mentioned. A second is a set of multilateral efforts through the IMF and the OECD, and then third is a set of actions within the government monitoring among the different agencies to improve our understanding and continually be able to report to Congress on the development of sovereign wealth funds.

Thank you.

[The prepared statement of Mr. McCormick can be found on page 134 of the appendix.]

Chairman GUTIERREZ. Thank you. Let me advise the witnesses that there is a little light up there. Green means to start, yellow means that you have 30 seconds left, and red means to stop. You have 5 minutes. I will tap very lightly up here as an extra reminder. We want you to finish your thought, and not be in a rush.

Mr. Tafara, please, you are recognized for 5 minutes.

**STATEMENT OF ETHIOPIS TAFARA, DIRECTOR, OFFICE OF INTERNATIONAL AFFAIRS, U.S. SECURITIES AND EXCHANGE COMMISSION**

Mr. TAFARA. Mr. Chairman, thank you for inviting me to testify on behalf of the Securities and Exchange Commission on the subject of foreign government investment in the U.S. economy and financial sector.

I am going to say a few words about the impact of sovereign wealth funds on the U.S. capital market and SEC regulations regarding these entities.

Today, sovereign wealth funds hold by some estimates more than $2.5 trillion in assets. Some projections estimate that their size will increase fivefold by the middle of the next decade, quite possibly making these funds collectively and individually the largest shareholders in many of the world's biggest companies.

Sovereign wealth fund investment in the United States is not new. Sovereign wealth funds based on foreign exchange reserves have always tended to invest abroad since their capital was based on foreign currency.

One thing that is new, however, is the size of their investment in the equity markets for public companies and their concomitant focus away from bond markets.

Sovereign wealth investment in the U.S. capital market offers definite benefits. Foreign investors, including sovereign wealth funds, that invest in the United States can offer U.S. companies a lower cost of capital and a more liquid market for their securities than might otherwise be available.

However, sovereign wealth funds raise a number of concerns for regulators and other market participants. Some of these concerns mirror those raised by large funds, generally.

In particular, by combining the foreign exchange reserves brought about by thousands or millions of international transactions, an investment fund can wield enormous clout on a market. This creates opportunities for market manipulation and where the

entity owns enough shares of an issuer to control it, it possibly raises issues with respect to insider trading as well.

It also raises classic corporate governance issues particularly in the case of creeping takeovers where minority shareholders are unaware of a pending takeover and suddenly find the value of the shares reduced once the takeover is complete.

Sovereign wealth funds also raise other issues. Because the fund manager is the government, it may have different and more complex incentives than those that normally drive private market participants to make decisions.

This is an issue that Chairman Cox has touched on in the past, the concern that sovereign wealth funds, because they are national entities, may not necessarily act like ordinary market participants, and therefore may have a distorting effect on a market.

Sovereign wealth funds are not necessarily transparent in their motivations or operations. This is particularly true when sovereign wealth funds are linked to a nation's foreign exchange reserves.

As you are all aware, exchange rate policies traditionally are closely tied to matters relating to national sovereignty, trade policy, and a nation's economy.

The point here is that sovereigns are not just concerned about making a profit. They have other national objectives as well.

The SEC's mandate is focused on investor protection, maintaining fair and orderly markets, and capital formation. Consequently, the SEC has in place several rules that require disclosure of sovereign wealth activities that address many of the concerns we hear voiced here and in other markets.

For example, the SEC requires that any beneficial owner holding 10 percent or more of an issuer's equity securities disclose their ownership and any change in this interest.

Likewise, the SEC requires beneficial owners of 5 percent or more of an issuer's equity securities to disclose the ownership, the source and amount of funds being used to purchase the securities, and their future intentions with regard to this ownership interest.

Finally, the SEC requires fund managers to exercise investment discretion over $100 million or more of SEC registered securities to file a quarterly disclosure of the fund's long holdings of these securities, as well as whether they have exercised voting authority over these shares.

Of course, such requirements are only as strong as the mechanisms we have in place to enforce compliance. In this regard, the Commission has the power to pursue sovereign wealth funds that violate U.S. securities laws.

Neither the United States nor international law shields foreign countries' commercial activities in the United States from the jurisdiction of the U.S. courts. The SEC has a strong track record investigating cross border violations of our securities laws, which we do working closely with our foreign counterparts.

The issue that arises with sovereign wealth funds is the possibility that the same government from whom we seek assistance might also be the controlling person behind the entity under investigation.

I should note that the concerns about sovereign wealth funds are not just concerns in the United States, but they are concerns in other jurisdictions as well.

Currently, the IMF, the OECD, and the European Commission are discussing best practices for sovereign wealth funds that in many ways mirror our own disclosure requirements.

I find these international developments comforting because I believe that at least with regard to the disclosures that sovereign wealth funds should make, there appears to be widespread consensus that we are on the right track.

Indeed, I would argue that we here in the United States are ahead of the curve on this, given that these disclosures are not voluntary but mandatory, at least for a sovereign wealth fund of any size.

Finally, sovereign wealth funds historically have been long-term investors, and many of their recent investments in troubled industries seem to follow this trend.

We should be aware that if we prohibit sovereign wealth funds from investing in our market for fear they might introduce market distortions, we might actually end up doing precisely this ourselves through the prohibition, that a better approach is to address the underlying issues of transparency, independent regulation, de-politicizing of investment decisions, and conflicts of interest.

Thank you for inviting me to appear today and I would be happy to answer any questions.

[The prepared statement of Mr. Tafara can be found on page 155 of the appendix.]

Chairman GUTIERREZ. Thank you very much.

Mr. Alvarez, you are recognized for 5 minutes.

**STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. ALVAREZ. Chairman Gutierrez, Ranking Member Paul, and members of the subcommittee, I am pleased to be here today.

I will focus my remarks on a narrow issue, the thresholds that trigger review by the Federal Reserve and the other Federal banking agencies of investments by sovereign wealth funds in U.S. banking organizations.

As a general matter, investments by sovereign wealth funds are subject to the same statutory and regulatory thresholds and requirements for review by the Federal banking agencies as apply to investments by other domestic and foreign investors in U.S. banking organizations. These requirements are established primarily in two Federal statutes, the Bank Holding Company Act and the Change In Bank Control Act.

The Bank Holding Company Act requires any company to obtain approval from the Federal Reserve before making an investment in a U.S. bank or bank holding company, if the investment meets certain thresholds.

In particular, the Bank Holding Company Act requires Board review when a company acquires ownership or control of 25 percent or more of any class of voting securities of a bank or bank holding company, control of the election of a majority of the board of directors of the banking organization, or the ability to exercise a control-

ling influence over the management or policies of the bank or bank holding company.

In determining whether an investor may exercise a controlling influence over the management or policies of a U.S. banking organization and thereby trigger formal review of the investment, the Board considers the size of the investment, the involvement of the investor in the management of the banking organization, any business relationships between the investor and the banking organization, and a number of other relevant factors.

The Bank Holding Company Act itself presumes that an investor that controls less than 5 percent of the voting shares of a banking organization does not have a controlling influence over that organization, and based on its experience, the Board generally has not found that a controlling influence exists if the investment represents less than 10 percent of the organization's voting shares.

The Bank Holding Company Act sets forth the standards that the Board must consider in acting on an application by a company to acquire a bank or bank holding company. Those standards require review of the competitive, supervisory, convenience and needs, financial and managerial effects of the transaction.

The managerial standard includes consideration of the competence, experience, and integrity of the investor.

Upon the acquisition of control of a U.S. bank or bank holding company, the investing company would by statute become subject to supervision by the Federal Reserve, including examination, reporting, and capital requirements, as well as to the Act's restrictions on the mixing of banking and commerce.

Importantly, the restrictions of Sections 23A and 23B of the Federal Reserve Act, which impose quantitative and qualitative limitations on transactions between U.S. banks and their affiliates, would apply to transactions between the U.S. bank and any company, including a sovereign wealth fund, that controls a U.S. banking organization.

These restrictions help assure that the U.S. bank does not engage in unsafe or unsound practices for the benefit of the parent company or any other affiliate.

Investments by sovereign wealth funds that do not trigger the prior approval requirement under the Bank Holding Company Act may nevertheless require review by a Federal banking agency under the Change in Bank Control Act. Prior review under that Act is generally required for any acquisition of 10 percent or more of the voting securities of a U.S. banking organization.

The Change in Bank Control Act also establishes specific standards that must be considered, and those standards focus on the competitive effects of the proposal, the managerial competence, experience, integrity, and financial strength of the acquirer, certain informational requirements, and whether the transaction would result in an adverse effect on the Deposit Insurance Fund.

Unlike the Bank Holding Company Act, however, the Change in Bank Control Act does not impose any activity limitations or any ongoing supervisory requirements on the owners of banks.

The recent investments by sovereign wealth funds in U.S. financial institutions have remained below 10 percent, and often below 5 percent, of the voting equity of the banking organization.

Consequently, these investments have not triggered the formal review requirements of either the Bank Holding Company Act or the Change in Bank Control Act.

Sovereign wealth funds have been a beneficial source of capital for U.S. financial institutions. Over the past several months, sovereign wealth funds have provided equity capital to U.S. financial firms that accounts for a significant portion of the total additional capital raised by these companies during this recent period of stress.

All of these investments, as well as similar investments made by U.S. private equity firms, have been structured as passive investments that do not trigger the thresholds that require review.

If, however, the investment were structured to represent control, it would be reviewed by the Federal banking agencies in accordance with the statutes that Congress has enacted.

Thank you very much. I would be happy to answer any questions you might have.

[The prepared statement of Mr. Alvarez can be found on page 61 of the appendix.]

Chairman GUTIERREZ. I thank the witnesses for their presentations.

Mr. Tafara, in your testimony, you referred to "significant policy issues that are raised by foreign government ownership of a U.S. bank." How are those issues different or mitigated by a separate corporate structure like a sovereign wealth fund owning a U.S. bank?

I am sorry. I mean that for Mr. Alvarez.

Mr. ALVAREZ. If the investment is made through a sovereign wealth fund, a corporation owned by the government and it is made in a banking organization, that would be subject to review by the Federal Reserve or one of the other banking agencies if it reached various thresholds.

Those investments made directly by a foreign government generally are not subject to review under the banking laws. There is an extra level of transparency and review potential for investments made through sovereign wealth funds.

Chairman GUTIERREZ. You think it is more?

Mr. ALVAREZ. I think there is more protection when the investments are made through a sovereign wealth fund.

Chairman GUTIERREZ. What is the difference for you?

Mr. ALVAREZ. The difference for me is that the Bank Holding Company Act only gives us authority to review transactions made by a company. A foreign government is not a company, so it is not subject to the Bank Holding Company Act.

Sovereign wealth funds are all incorporated or a partnership or—

Chairman GUTIERREZ. Do you think there should be such a distinction?

Mr. ALVAREZ. I am not quite sure if we want to effect foreign policy through the Bank Holding Company Act. I understand the sensitivity in crafting the definition as Congress has crafted it so far.

Chairman GUTIERREZ. Interesting. Thank you.

Mr. McCormick, by now, we are all aware of the major sovereign wealth fund investments that were made in U.S. financial institutions in late 2007. After that surge we saw in December, reports

indicate that the value of U.S. acquisition of foreign buyers dropped to $25.4 billion in the first 2 months of 2008, and that is down 50 percent from a year ago.

Foreign buyers dropped to $11.1 billion in transactions in the United States in January, the lowest monthly total since May 2006.

As a percentage of overall U.S. deal volume, acquisition by overseas buyers has shrunk. In January and February, the value of U.S. acquisition by foreign buyers accounted for 15.8 and 15.3 percent of U.S. deal volume, respectively. This compares to last year when it constituted 23 percent.

In light of these numbers, are you concerned that we actually may be facing a substantial drop-off in foreign direct investment, and if a drop-off is taking place, what do you think is the cost?

Mr. MCCORMICK. Mr. Chairman, I think if you look at the broader U.S. investment numbers into the United States over the past—

Chairman GUTIERREZ. Mr. McCormick, could you pull the microphone just a little bit closer? Thank you.

Mr. MCCORMICK. If you look at the data over the last year in terms of the investment numbers, in all asset classes and in all foreign investment, I think you would see that there has been a pretty healthy investment throughout the 12-month period.

In the period of August/September, we saw a pretty significant drop-off in the investment data, which then recovered and we had strong months in October and November and a little bit of a downturn in December.

There has clearly been some shifting that has taken place between different asset classes. In other words, whether foreign firms are investing in other firms or equities or treasuries, the overall investment numbers in the United States remain strong year over year.

Chairman GUTIERREZ. Mr. Tafara, you indicated that when a fund manager or business owner is a government, it may have different incentives than those that normally drive private sector participants to make decisions.

This really goes to the heart of many concerns with foreign sovereign investments in the United States. You asked the question in your testimony, "If government controlled companies and investment funds increasingly direct the investment of business and capital, what will be the effect on the pricing of assets and the allocation of resources?"

I would like you to answer your own question. What are the potential distorted effects of government controlled investments?

Mr. TAFARA. For me, what becomes important in that situation is that there be transparency with regard to motivations of a sovereign wealth fund in making an asset purchase.

The manner in which I would answer my question is to say that provisions like Section 13 of the Securities and Exchange Act become important because they require that there be disclosure as to what your motivations are with respect to a stake that you take in a company, and that transparency can provide a sense of comfort as to what the sovereign wealth fund intends for a particular company.

Potential distortions: I think the distortions that people like to talk about are the worst-case scenario that they like to present, that a sovereign takes a stake that it holds in multiple U.S. companies and dumps them.

If you look at the size of sovereign wealth funds against the market capitalization in the United States, it is pretty small. We are talking about a couple of trillion, whereas market capitalization in the United States is between $50- and $60 trillion.

At the end of the day, that dumping would have some impact upon the market, but I think you would find there is enough liquidity there that others would come and pick up what would be a fire sale, because the assets that are being dumped would have value, despite the motivations of the sovereign wealth fund.

Chairman GUTIERREZ. Thank you very much. Mr. Alvarez, we will be following up with you. Mr. Bernanke is kind of busy these days, so maybe we will take up some time with you.

I think it is a serious concern in distinguishing between a government and a foreign investment entity owning an American financial institution. I think we really should take a look at that.

Thank you, Mr. Alvarez, for the candor of your answer.

Congressman Paul, you are recognized for 5 minutes.

Dr. PAUL. Thank you, Mr. Chairman.

I have just a brief question for the panel and it is a follow-up from my opening statement dealing with monetary policy, just wondering how the panel feels about whether or not this problem is much of our own making, and part of the system of money that we follow.

When a country has a currency that is commodity-backed, there is always a limit to the current account deficit because you cannot keep exporting the currency. You run out of money. You have to go back to work. Your prices drop. Then your currency comes back in or real value comes back in. It is self-adjusting.

The system that we have today is quite different, especially for the country that is privileged to issue the currency of the world, the reserve currency. We have had that privilege. We have literally been given license to create money out of thin air, export our money, and then eventually there is an accumulation, and once there is a sense that the value of the currency, the dollar, is going down, we best invest it more wisely, and that is what we are facing, and that makes a lot of people nervous.

In one way, it is a problem for some people, but in another way, it is self-adjusting in a different manner, that those dollars are coming back in and buying up hard assets.

The question I have is really when you think about this problem, do you think about it as a consequence of a monetary system or is it always just because we have overextended ourselves and if we just have more regulation—I sort of sense it is a big problem. We are dealing with a symptom and we think if we adjust this with some regulations, and say we will pick and choose, we are trying to do what the market could have done in a much more orderly fashion.

I would like to see if I can get some comments on that issue. Mr. McCormick?

Mr. MCCORMICK. Congressman Paul, I would first of all begin with the acknowledgement that sovereign wealth funds are just one small sliver of a set of global imbalances which are driven by a whole set of macroeconomic factors.

What we try to differentiate as we think about the policy response to the fact that there are some root causes—both on the commodity and the non-commodity side for the funds, for example, on the non-commodity side, the lack of market driven currencies in some countries around the world, namely China, is one that is particularly noteworthy—from the fact that these sovereign wealth funds exist, and these investment flows exist.

When we have thought about a policy response, recognizing there is a whole set of macroeconomic policies and issues, the policy response on sovereign wealth funds has been very much targeted on the fact that these investment flows exist and will continue to grow, and how do we best accommodate those, not with regulation from our perspective, but in terms of a set of voluntary best practices that would give some assurances around the intent of that investment being commercially driven.

Dr. PAUL. Would anybody else care to make a comment?

[No response]

Dr. PAUL. I do not have any further questions.

Chairman GUTIERREZ. Thank you very much. Chairman Kanjorski, you are recognized for 5 minutes.

Chairman KANJORSKI. Thank you, Mr. Chairman.

I do not see enough gray hair to maybe remember what I am going to refer to; do any of you remember the BCCI scandal? I see that Mr. Alvarez does.

The reason I bring that up is I recall testimony some 20 years ago or more where Clark Clifford and Mr. Altman were involved in controlling certain banks that were in a line of ownership of foreign banks, and the banks that they were in charge of were American banks.

We had before us one afternoon a former United States Senator, for whom I had a great deal of admiration, Matt Mathias, if you remember, from Maryland. He did not testify. He just sat in the audience and listened.

Immediately after the hearing, he contacted me and wanted to go to lunch with me. I had no idea why he would want to see a lowly Congressman from Pennsylvania, but he did. We went to lunch.

He said in a very nervous way, "Congressman, I am frightened to death; I do not know what to do. I am a director of an American bank, and I have spent a considerable amount of time, more than a year, and I cannot determine who owns the bank that owns my bank or who appointed me director of my bank or what banks my bank owns."

I was listening to all the regulations, Mr. Alvarez, you said the Federal Reserve had. The question is, how much work do they do to follow that line of who does what, when, and where, and under what circumstances?

Or are the powers you are referring to all new powers that never existed 20 years ago?

Mr. ALVAREZ. The Bank Holding Company Act and essentially what I outlined was enacted in 1956 and tightened up in 1970, and then the Change in Bank Control Act is 1978.

You may recall, in BCCI, that the investors there intentionally hid their ownership relationship from the regulators. There was in fact an application filed with the Federal Reserve. The true owners lied about their involvement. That was not a flaw in the Act. That was an intentional attempt to avoid—

Chairman KANJORSKI. How was that corrected? Why could I not do the same thing today?

Mr. ALVAREZ. Fraud is always a difficult thing to prevent, and there is no law that can absolutely prevent fraud. We do the best we can to follow-up on—

Chairman KANJORSKI. Mr. Alvarez, you gave me the impression when you were testifying that there was a methodology and a process here that should make us all feel very secure that we are not going to have a problem with sovereign wealth funds. Yet, if they want to be devious, just like the BCCI problem, they can be devious. They can accomplish many things.

Let me give you an example of what I am worried about: $69 billion has been invested in the last 9 months in American financial institutions, forgetting other institutions.

We know that we have certain limitations on exercise of power by banks. If you have more than 10 percent of the deposit accounts in the country, you cannot buy additional banks to gain greater than the 10 percent. You are limited. We do that because we do not want one bank dominating all of the deposits in the United States. I think that is good public policy.

Recently, you are probably aware of the fact that there has been tremendous pressure by some large banking institutions in the United States that are hitting that cap, that are making the argument that they can grow, they do good business and they do, and they want us to raise that cap.

Sometimes the pressures they put on us are to say well, if you do not allow us to raise the cap, the State of Illinois is not going to get economic funding for its progress, and the chairman is going to be responsible for the loss of employment. There is a great sympathy in the Congress to attempt to accommodate.

What is going to stop us from seeing, when we go from $2 trillion in sovereign wealth funds to $15 trillion, a sevenfold growth in a matter of a decade?

They are going to be so placed in the American market that they are going to be able to say look, you are either going to allow us to exercise more power, more influence, more control, more ownership, or your financial institutions are going to fail. Because, after all, your people have a negative savings rate of 2 percent. You are not going to pick it up from American citizens. You are going to pick it up from the foreign countries and will that not happen, or is there not that potential to happen?

What are we going to do to make sure there is not an abuse of power, particularly from a strategic standpoint?

We make a very classic assumption in this country: Since we are a capitalist nation, we believe that everybody is driven by profit.

Some countries are not driven by profit. They are driven by political and national interests and security.

Now we are dealing directly with the funds of countries that in some instances are adversaries of ours. If I were China, I would put my sovereign wealth funds highly invested in the energy field of the United States. I would buy as many electric utilities as I could, and then at my own desire, rather than sending an army over here some time in the future or an airplane to do damage, I would just issue the order as the owner of the electrical utility networks of the United States to turn off the power.

What is going to stop them from doing that?

Mr. ALVAREZ. I obviously cannot speak to electric power companies and how we will deal with that. I do have a lot of faith in the backbone of Congress to stop things when there is pressure.

I think in the banking area, one thing we can take comfort in is that so far, the sovereign wealth funds have not taken significant interest in any banking organization. They have not taken positions that would allow them to shut off credit or limit—

Chairman KANJORSKI. That is not quite true. You know that when we had bank failures, the FDIC went in and paid deposits that were way in excess of $100,000 insurance in order not to discourage foreigners from investing in American banks or depositing in American banks.

What national banks failed in New York? We went in literally with hundreds and millions of dollars to cover Middle Eastern money deposits that were not covered under the Act. We had no obligation. As a matter of fact, there was no power except a political decision made in the United States that if we failed to honor those deposits with insurance, we would not get future deposits, and it could cause a disruption in the investments in U.S. banks. Is that not correct?

Mr. ALVAREZ. Sir, if I could say two things on that. First, that was not the result of foreign ownership of a bank. That was because of deposits placed in the bank.

And second, Congress did address that situation and stopped the FDIC from paying uninsured deposits by putting in place depositor preference requirements, least cost resolution, and other limitations that prevent that kind of resolution again.

Chairman KANJORSKI. Before those protective laws were passed or regulations made, it was expeditiously and politically decided that we would act contrary to the law to satisfy the need of retaining those deposits.

What I am saying is, do you not see the corollary, that if we are trying to entice private individual funds and avoid our own laws and regulations in the banking institutions, we sure as hell are going to do it with government funds, or do you not see that?

Mr. ALVAREZ. No. I see your point. I appreciate your point. There are certainly costs that are associated with allowing investments freely. There are benefits as well.

I think one of the things that is important for Congress to do is consider both the costs and the benefits and try to devise a system that they think is best.

Chairman GUTIERREZ. Thank you, Mr. Alvarez. The time of the gentleman has expired. The ranking member of the full committee, Mr. Bachus, is recognized for 5 minutes.

Mr. BACHUS. I thank the chairman. I do believe this is a very important hearing. There has been a lot of conversation about foreign government investment in the financial services industry and the U.S. economy as a whole.

What Mr. Alvarez said, I actually came down here to give this statement because I did want at least a balanced approach to this, and there are benefits.

The past few months, we have seen exceeding stress and challenging times for both the U.S. economy and for the financial services industry. During that time, we should never forget this, we have had extraordinary infusions of capital from sovereign investment funds and to some of our largest banks.

What has that done? What is the result of that? The first result, and I am actually going to read a statement instead of ask questions, but the first result is that these banks have shored up their capital reserves. That is nothing but a positive.

Second, by increasing their reserves, we really have enhanced the safety and soundness of our financial system.

I am very grateful that source of funds was available.

No one can disagree that the vitality of our financial services sector is critical to the Nation's continued economic growth.

These recent capital infusions given by the sovereign wealth funds and the countries that administer them, it has given them a vested interest, not only in the companies, but more importantly, it has given them a vested interest in the continuing health of the U.S. financial services industry and the U.S. economy.

Like any investor, a sovereign wealth fund expects their investments to succeed. It is in their economic self-interest that U.S. industries in which they have invested continue to grow and prosper.

It is in the interest of the United States and our economy to welcome this investment. Foreign investment, whether from a private investor who lives abroad, a publicly listed company that trades on a foreign exchange, or from a sovereign wealth fund, creates jobs in the United States and fosters economic growth.

I can tell you as a Member of Congress who has Honda and Mercedes in my District, and many of their workers, that foreign investment has created very high-paying jobs in my District.

Nonetheless, I would agree there are important questions that we have to ask about the growth of these sovereign wealth funds. We must ensure that we have policies in place that prevent this investment, however welcome it is, from compromising our national security. We must ensure that these sovereign wealth funds play by the same rules that all large investors play by when they invest in U.S. companies, and we must ensure that sovereign wealth funds do not pursue purely nationalistic or strategic economic objectives at the expense of U.S. companies in which they invest.

We cannot forget that capital today is more mobile than it has ever been in the history of the world, and that capital can and will travel anywhere.

We must reserve the right to reject foreign investments that compromise our national security or place us at an economic disadvan-

tage, but we must also avoid, and it is very critical that we avoid creating an investment climate that is hostile to legitimate foreign investment.

If we do, the world's capital will simply flow elsewhere. Investments will be made outside the United States and jobs created, perhaps with far more serious and harmful long-term effects on our own economy.

The key principles must be transparency and fairness. We should insist on equal treatment for U.S. investment, meaning that we should be able to invest in other countries in the same way they invest here.

To address the national security concerns, you will recall Congress passed a strong bipartisan legislation last year, written by this committee, to reform the process followed by the Committee on Foreign Investment in the United States, or as most of us refer to it, CFIUS.

We established a thorough mechanism to review proposed investments for threats to national security and to ensure greater government accountability in the approval process. That has already been done.

Mr. Chairman, while remaining vigilant to potential threats to our national security and our economy, our country must act responsibly to maintain and encourage an environment that is free and open to international investment. Our welfare and our economy depends on it, so that all Americans can continue to benefit from inflows of foreign capital that create jobs and fuel economic growth here in the United States.

Thank you, Mr. Chairman.

Chairman GUTIERREZ. Thank you, Mr. Bachus. Are there any other members who wish to ask questions of this panel before we recess?

[No response]

Chairman GUTIERREZ. We have exactly 6 minutes. We will recess, we will take our votes, and we will immediately come back. We will be right back with you. Thank you.

[Recess]

Chairman GUTIERREZ. We will come to order. The Chair will recognize, for 5 minutes, Mr. Jones. Congressman, please.

Mr. JONES. Mr. Chairman, thank you very much. I want to thank you, and I want to thank the panel for waiting as long as you have, and hopefully some other members wanted to ask you questions.

This question that I would like to ask would be of Mr. McCormick or Mr. Alvarez. I represent the Third District of North Carolina, and I hear constantly from the people of my District, why in the world is our Nation in such a bad financial state that we continue borrow more and more money from foreign governments?

I am looking at an article from CNNmoney.com, "Feds to Auction Another $60 Billion."

Just very quickly before I get to the question, the Federal Reserve announced Friday that it will auction another $60 billion in March as it continues to combat the effects of a severe credit crisis.

It repeated a pledge to keep holding the auctions for as long as necessary. The Central Bank said it will make $30 billion available

to cash strapped banks at each of two auctions on March 10th and 24th.

Last week, we had Mr. Zandi here, Dr. Mark Zandi, with Moody's. I asked him quite frankly: How much longer can this Nation continue to borrow money? I know we are talking about foreign governments investing in banks and all this, and I realize that.

The point comes to this: We owe China $447 billion and most of that debt that China holds is in the way of Treasury notes. There has to come a time that we get to a point of no return. What the average taxpayer wants to know and by the way, I am an average taxpayer, is how long do we keep going before the whole economy of this country will just collapse?

I will ask Mr. Alvarez because the Federal Reserve is putting these bonds out there, or I will ask Mr. McCormick.

There comes a time where I do not know how this country can continue to float the way it has economically without—if you let me use this as an example—a hole in the bottom of the float and it sinks.

Mr. MCCORMICK. Congressman, maybe I can take a quick shot at it, giving you an answer, and then turning to my colleague if he has something to add.

I think if you step back and look at the trends over the last couple of years, two things would be notable. One, the current account deficit has actually decreased fairly dramatically over the last 12 to 18 months from roughly 6.8 percent of GDP to 5.1 percent of GDP. The deficit as a percentage of GDP has also decreased quite significantly.

The projections going forward with the recent budget are that the deficit will go back up as a percentage of GDP, but in relative terms, it has decreased quite significantly.

That is one set of issues. The second set of issues is the foreign investment coming into the United States, sovereign or other. There are a number of reasons that is occurring.

The broader imbalances that Mr. Paul mentioned certainly is part of it. The attractiveness of our investment climate is another component of it, and Congressman, that is something that I think we should celebrate, that foreign investment is coming into the United States, it is investing in U.S. assets. That is good for us. It is good for our prosperity.

Mr. JONES. Excuse me. Is the fact that China owns $447 billion of our Treasury notes, do you consider that an investment?

Mr. MCCORMICK. Yes, Congressman, I do.

Mr. JONES. What happens if China will not hold these notes for 20 years, but instead decides in 5 years that they want to sell those notes, and they want to play havoc with America's financial markets? They could do that overnight.

Mr. MCCORMICK. Congressman, they could. I think on the list of owners of U.S. Treasuries, they are second or third on the list. Japan is number one on the list. There are a number of owners.

That is a validation, I think, in confidence in the United States, and that is a very liquid market, as you know. There are many buyers for it. China's interest is to invest in places where it is going to get maximum return.

Mr. JONES. Mr. Alvarez, if you could, I have about 2 minutes. My time will be up. The issue is if we keep putting all these bonds out there to be sold, billions here and billions there, I would never argue with any economist or people like yourselves, you are the professionals, but it has been proven in the history books that great nations that have to borrow money from foreign governments to pay their bills do not long remain great nations, because what is going to happen is that great nation is going to sink because its dollar has very little value.

Mr. ALVAREZ. This is a debate that has gone on in this country since Alexander Hamilton who believed that putting debt out into the public actually gained the respect of others who would then have an interest that would align with your interest, so the self-interest of the investor and the country would be aligned and helpful.

I would like to make one point if I could about the term "auction facility" that you referenced, the $60 billion that the Federal Reserve is lending. That is not borrowing by us; that is lending by the Federal Reserve to banks to help in the short-term money market. It is a very different kind of thing.

I think the concerns you raised should not be directed in that direction. I would be happy to talk with you more about that at another time.

Mr. JONES. Thank you.

Chairman GUTIERREZ. Thank you very much. I thank the panel for its patience. I am happy that you waited for us to come back. I thank you so much. You are all excused. Thank you so much.

We will be sitting the second panel. Thank you so much.

This is the second panel we have this afternoon. First on our panel is Mr. Martin Skancke. Mr. Skancke is the director general of the Asset Management Department of the Ministry of Finance in Norway.

Next, we have Mr. Simon Israel, the executive director of Temasek Holdings. Mr. Israel worked extensively in the Asian Pacific region since the early 1980's with Sara Lee Corporation. He currently serves as chairman of the Singapore Tourism Board.

Third, we have Mr. David Denison. Mr. Denison is the president and CEO of the Canada Pension Plan Investment Board. Mr. Denison has 24 years of experience in the financial services sector, including senior postings in the investment consulting and mutual fund businesses in Canada, the United States, and Europe.

And finally, we have Professor Matthew Slaughter. Professor Slaughter is an associate dean of the MBA Program and Professor of International Economics at the Tuck School of Business at Dartmouth. He is also currently a research associate at the National Bureau of Economic Research and a senior fellow at the Council on Foreign Relations.

I welcome you all to the hearing. Mr. Skancke, you are recognized for 5 minutes.

**STATEMENT OF MARTIN SKANCKE, DIRECTOR GENERAL, ASSET MANAGEMENT DEPARTMENT, NORWEGIAN MINISTRY OF FINANCE**

Mr. SKANCKE. Thank you very much, Mr. Chairman. Thank you for the invitation to address this distinguished committee on issues related to sovereign wealth funds and their investments in the United States.

The Norwegian Government Pension Fund is a large global investor with assets around $380 billion. We are adding about $1 billion per week in new funds to this portfolio.

One-third of the portfolio, about $125 billion, is invested in bonds and equities in the U.S. market. The United States is by far the largest recipient country for our investments.

The Fund has a twofold purpose of smoothing out the spending of volatile revenues, and at the same time, acting as a long-term savings vehicle, allowing the Norwegian Government to accumulate financial assets in order to help cope with large future financial commitments associated with an aging population.

To effectively shield the non-oil economy from the effects of a volatile flow of foreign currency, earnings from the oil sector, the Fund has only invested abroad.

The management of the Fund is based on a few basic principles. First, the Fund is a pure financial investor with non-strategic holdings. The objective of the Fund is to maximize financial returns.

There are clear lines of responsibility between the Ministry of Finance's former owner of the Fund and the Central Bank as operational manager. There is a high degree of transparency in all aspects of its purpose and operation.

The equity portion of the Fund is in the process of being increased to 60 percent from 40 percent previously. The rest is invested in bonds, including real estate in the Fund's strategic benchmark that is under consideration.

We believe that sovereign wealth funds are perhaps particularly suited to contribute to stability in the international financial markets. They typically have a long-term horizon for their investments. They are not leveraged. There are no imminent claims for withdrawal of funds in turbulent markets, as we have seen recently.

Turning to the question of transparency, which is very topical at the moment, we believe that transparency has several benefits. It is a key tool in building trust, both domestically and internationally. It provides a disciplinary effect on fund management, and it may in itself contribute to stabilizing international financial markets.

We, therefore, support the efforts of the IMF to establish a set of best practices for funds in this area.

However, transparency is a very abstract concept, and we need to have a more granular approach if we are to make progress in this area.

It may be useful to distinguish between different areas of transparency. Transparency with respect to governance structure, who are the ultimate owners, who makes investment decisions, and what are the arrangements for audit, supervision, and control.

Investment objectives: What is the purpose of the Fund, the time horizon, the rules governing allocation of withdrawals, and the investment strategy and implementation.

Obviously, the last category will be the most difficult to address, but even transparency about governance structure and investment objectives should go a long way towards alleviating concerns about sovereign wealth fund investments, and claims for increased transparency has to be balanced against legitimate business interests of investors.

Transparency has to run both ways. If recipient countries set up screening processes to address perfectly legitimate national security concerns, there must be transparency with respect to how such screening decisions are made, by whom, and under what criteria.

Lack of transparency in this area will lead to suspicions of financial protectionism, introduce an element of uncertainty to the investment process, reduce investor confidence, and may ultimately reduce the relative attractiveness of a non-transparent recipient country.

As I have explained, the Fund is a major shareholder in the U.S. market and the holdings of U.S. equities will increase significantly in the years to come. This reflects the size and importance of the U.S. market but also our confidence in the long-term potential of this market.

We are not running from the market in these more turbulent times but are building up our portfolio based on a long-term view.

The Fund is not a strategic investor. It will not take over businesses and run them. Even as a pure financial investor, the Fund has to use its ownership rights as investors to protect its long-term financial interest.

The Central Bank as manager has published a document outlining the priorities and principles our corporate governance work is built on.

They published yesterday a full record of how they have voted on every single issue in every single company they have voted, almost 40,000 individual issues, in more than 4,000 companies globally.

There are no hidden agendas in our corporate governance work.

The Pension Fund has a very long time horizon. It will in principle be permanently invested in global markets. It is in our interest that companies we invest in are well-run, profitable, and operate in well-functioning markets, and a sound regulatory framework and good corporate governance arrangements are important preconditions for this.

Thank you very much.

[The prepared statement of Mr. Skancke can be found on page 139 of the appendix.]

Chairman GUTIERREZ. Thank you very much.

Mr. Israel?

**STATEMENT OF SIMON CLAUDE ISRAEL, EXECUTIVE DIRECTOR, TEMASEK HOLDINGS (PRIVATE) LIMITED**

Mr. ISRAEL. Thank you, Mr. Chairman.

The Singapore Government founded Temasek in 1974 to hold and manage investments in several government firms they owned at the time. The objective was to separate the role of managing

commercial investments from the government's role of policymaker and regulator.

Temasek's charter is to manage these investments independent of the government on a purely commercial basis, in order to generate sustainable returns for the benefit of future generations.

In order to maximize and balance portfolio risks, Temasek invests internationally within a directional framework of being invested one-third Singapore, one-third Asia, one-third the OECD, over time. This allocation is flexible in respect of its weighting and is subject to both the state of markets and investment opportunities at a given time.

Temasek seeks to have a portfolio which is diversified by geography and sector. At this time, our portfolio is weighted towards Asia and towards financial services, telecommunications, and transportation, which are proxies for economic growth in emerging markets.

On ownership and governance, Temasek is incorporated as a private company with a sole shareholder, the Ministry of Finance. While Temasek is state-owned, it is not state-directed.

Temasek is governed by a Board of Directors, the majority of whom are independent directors from the private sector. It is the Board which approves Temasek's investment strategy and investments. Independent non-executive directors chair the three key committees that assist the Board.

Under the Singapore Companies Act, all directors are charged with the fiduciary duty of acting in the best interest of the company and its shareholders. As with all companies, the CEO reports solely to the Board.

In addition, Temasek is advised by a 10-member Temasek international advisory panel, comprising international business leaders, including two Americans, to provide the firm with global perspectives and advice.

Given Temasek's independence from the government, Temasek does not discuss individual acquisitions or the management of such investments with the government.

The government evaluates Temasek's performance on the basis of the returns of the overall portfolio at the time.

Temasek's source of funds comes from its investment activities, notably dividends, proceeds from divestments, a modest level of debt, and occasional injections from our shareholder.

For purposes of clarity, Temasek owns its assets. It is not a fund manager.

Singapore's constitution reinforces Temasek's independence. The constitution limits the ability of the government to draw on Temasek's assets or to politically influence the selection and work of the firm's directors and its chief executives.

Temasek's charter as a private commercial investor is to maximize sustainable returns. We have done so, earning an 18 percent compound annual return since inception. Fundamentally, this result has only been achievable due to our engaged Board, sound governance, and professional management.

Temasek seeks to employ the best international investment professionals; 40 percent of our senior management are non-Singaporian, including Americans.

On disclosure and transparency, Temasek recognizes the importance of good corporate governance. Good governance requires adequate disclosure and transparency.

The firm is audited by international auditing firms, and since 2004, it has annually published its financial performance in the Temasek Review.

The Review includes an overview of the firm's governance process, investment themes, financial performance, portfolio holdings by geography and sector, major investments and divestments.

It also provides an indication of the firm's future direction. The firm also maintains a Web site allowing access to annual reviews and other information.

The firm has made further regular disclosures since 2005 when we received our AAA credit ratings from Standard & Poor's and Moody's. As a condition for receiving the ratings, both agencies thoroughly scrutinized Temasek, and as a condition for maintaining our ratings, every major transaction since has been scrutinized further to ensure financial discipline.

We also issued a maden U.S. Dollar Bond in 2005, which was and continues to be subject to SEC disclosure.

As a result of these disclosures, Temasek is acknowledged as a well-governed and accountable firm.

Temasek understands that there remain concerns about the role of state-owned entities, even if they are not state-directed, in the global markets. As an investor, Temasek believes that the IMF and the OECD are the best arenas in which to discuss this issue and to develop voluntary codes of conduct for state-owned entities and policies for investment receiving companies.

Temasek's recent investment in Merrill Lynch is only the latest linkage we have with the United States. Several Temasek portfolio companies have significant U.S. operations.

As you know, the United States and Singapore enjoy close strategic and economic relations. Temasek understands and fully respects that the United States must take measures necessary to protect its national security.

We have closely followed the enactment of the new Foreign Investment and National Security Act and the drafting of its regulations. We are aware of the vigorous debate in Europe and the United States with respect to sovereign wealth funds.

We encourage Congress to maintain the right balance in protecting national security in ways that continue the traditional welcoming attitude of the United States towards foreign investment.

Our course was set over 30 years ago when Temasek was created. As we look to increase our holdings outside Singapore and outside Asia, we remain committed to the commercial principles that have made us successful.

In the process, the firm will maintain its 3-decade role as an independent, commercially-driven, long-term investor in companies throughout the world.

Thank you.

[The prepared statement of Mr. Israel can be found on page 120 of the appendix.]

Chairman GUTIERREZ. Thank you very much.

Mr. Denison, you are recognized for 5 minutes.

**STATEMENT OF DAVID DENISON, PRESIDENT AND CEO, CANADA PENSION PLAN INVESTMENT BOARD**

Mr. DENISON. Mr. Chairman, thank you for inviting me to participate in this panel.

With regard to the issue of sovereign wealth funds, we recognize that policymakers around the world are trying to balance the requirement of openness towards foreign investment and the need to preserve national security.

Through this lens, one can readily see the challenges posed by some sovereign funds with billions of dollars of capital at their disposal, but little in the way of transparency, clarity of mandate, or public accountability.

I am pleased to appear before you today to share the CPP Investment Board's perspective on these matters.

Although we have the word "Canada" in our name, and we were created by an Act of Parliament, the CPP Investment Board is not a sovereign organization or a sovereign wealth fund.

You noted this, in fact, in your invitation letter which recognized that the CPPIB is not a sovereign wealth fund but rather an independent public pension fund that is technically owned by a foreign government but is also independent from government.

This is so for a number of reasons, most simply because we do not manage government assets nor are we controlled by any government. Indeed, the assets we manage belong to 17 million working Canadians and are strictly segregated from government funds.

Nonetheless, we have a perspective on the central issues of transparency and accountability that may be of interest to the committee.

At the heart of the sovereign funds' issue is the question of political control and the potential that sovereign funds may be used in support of national or political rather than economic goals.

The governance model of the CPP Investment Board is instructive in this regard because it was specifically designed to protect against political interference, while maintaining a high degree of accountability.

We have provided a written statement that expands on how these concepts are realized in our governance model, but for now, let me note the following points.

The CPP Investment Board was created to help sustain the Canada Pension Plan by investing those funds not needed to pay current benefits. Our mandate, which is enshrined in law, is to achieve a maximum rate of return without undue risk of loss.

Management of the CPP Investment Board reports not to government but to an independent board of highly qualified directors. The Board of Directors, not government, approves investment policies, determines with management the organization's strategic direction, and makes critical operational decisions, such as hiring the chief executive officer and determining executive compensation.

The CEO in turn hires and leads a management team including the investment professionals who make the portfolio decisions within investment policies that are agreed to by the Board of Directors.

To be clear, we do not submit our investment strategy or business plans for government approval. We do not have government officials sitting on our Board. We do not submit our policies for gov-

ernment approval, and indeed, our Code of Conduct stipulates that any attempt by government to influence our investment decisions, hiring practices, or procurement must be reported to the chairman or the CEO, who will take appropriate action.

It is in short a familiar private sector model but with strong public accountability. Accountability is achieved principally through transparency.

Our legislation requires a high level of transparency by audits, special examinations, and public meetings. Beyond that, our Board and management have voluntarily raised transparency to an even higher level.

For example, we report our results on the same basis as most Canadian public companies, including the presentation of independently audited financial statements. We post our investment policy and objectives on our Web site as well as a full list of all our public and private equity, real estate, and infrastructure holdings.

In short, we believe that it is possible to provide a very high degree of transparency without compromising our proprietary investment insights.

We believe that elements of Canada's blueprint could help address some of the concerns raised about sovereign wealth funds today.

These concerns can be alleviated to a great degree if such funds clearly articulate their investment objectives and their governance structure, and embrace a degree of transparency sufficient to enable others to measure their actions against their stated objectives.

In response to the emergence of sovereign wealth funds as active direct investors of significant scale, we are seeing calls for new protectionist legislation which could have negative consequences for the free flow of capital.

It seems to us the challenge for policymakers is to properly balance the desire for foreign investment with the need for security and transparency, and we submit a key to success can be found by looking beyond labels to examine the underlying characteristics of these large pools of capital according to some of the criteria I have outlined today.

Thank you.

[The prepared statement of Mr. Denison can be found on page 75 of the appendix.]

Chairman GUTIERREZ. Thank you, Mr. Denison.

Mr. Slaughter, you are recognized for 5 minutes.

**STATEMENT OF MATTHEW SLAUGHTER, PROFESSOR, TUCK SCHOOL OF BUSINESS, DARTMOUTH COLLEGE**

Mr. SLAUGHTER. Thank you. Mr. Chairman and members of the subcommittees, thank you for inviting me to testify on these important and timely issues.

Let me start by making three points about the economic benefits of sovereign wealth funds.

First, many sovereign wealth funds were created as legitimate stewards of national economic welfare, to manage fiscal surpluses for sound goals such as intergenerational transfers.

Here, it is important to remember that the United States itself is home to such funds, for example, the Alaska Permanent Reserve Fund.

Second, to the extent that sovereign wealth funds invest for commercial motives of high risk adjusted rates of return, the overall U.S. economy benefits from their investments.

America's commercial and investment banks are a prominent recent example of these benefits.

Funds' investments provided many leading banks with much-needed capital to stabilize their near term performance and thereby support the overall economy.

The United States has long benefitted from open global capital markets, of which these funds are now an important part.

Third, to date, the magnitude of sovereign investments into the United States remains quite small. At year end 2006, the rest of the world owned $17.4 trillion of American assets. The recent surge of investments into the United States by sovereign funds is a lot of money to you and me, but it is still a fraction of one percent of America's gross international investment position.

These economic benefits aside, the "s" in sovereign wealth funds presents a legitimate policy concern. Were these funds to operate for non-commercial reasons, they could damage the United States. Some of this damage could be economic but much more importantly, some of this damage could be to national security, were these funds to use their investments in American companies to further their strategic interests in conflict with those of the United States.

What to do about this legitimate policy concern: To answer, let me first list three important costs to the U.S. economy that we run the risk of incurring should excessive constraints be placed on these funds in an attempt to address this concern.

First, we could incur economic damage to U.S. companies at home. American companies have historically been strengthened by foreign investment. A tangible example of this is jobs. In 2005, there were 5.1 million Americans working for U.S. affiliates of foreign multinationals, earning an average annual compensation of over $66,000.

Second, we could incur economic damage to U.S. companies abroad. In a new Council on Foreign Relations' report, David Marchick and I have documented a new protectionist drift in inward investment policies around the world.

In this environment, new U.S. restrictions on inward investment here may well be met by similar restrictions abroad against U.S. companies, which would harm their global competitiveness.

Third, we could incur economic damage to the overall U.S. economy by raising the risk of a disorderly adjustment to the chronic U.S. current account deficits of recent decades.

To finance this excess of imports over exports caused by low U.S. national savings, each year the United States must on net sell an equivalent amount of assets to the rest of the world. The likelihood of a gradual orderly evolution of the U.S. current account deficit and of the value of the U.S. dollar will be higher the wider is the range of U.S. assets the rest of the world can reasonably purchase

and the wider is the range of foreign investors, including sovereign wealth funds.

Let me close my testimony with the second part of my reply to the question of what to do. For now, I would suggest two steps:

The first step is diligent U.S. participation in ongoing multilateral dialogues with sovereign wealth funds to generate more and more transparent information about their governance, goals, and strategies.

Recent interest in these funds has revealed that for many, there are some clear gaps in what we know, like in so many areas, here, too, sound public policy is best founded on complete and robust information.

An increase in the quality and quantity of information about sovereign funds should help allay many concerns about the likelihood of these funds operating for non-commercial reasons that could threaten U.S. security.

The second step is to urge support by all interested parties in the continued non-partisan operation of the Committee on Foreign Investment in the United States. CFIUS is well-suited to address any legitimate national security concerns raised by U.S. investments by sovereign wealth funds, or let me remind everyone, by any other foreign investor as well.

One important reason for this is that CFIUS does not have any statute of limitations, in that any inward transaction can be brought to CFIUS, not just before, but also after closing, should any concerns arise after the fact.

Thank you again for your time and interest, and I look forward to answering any questions you may have.

[The prepared statement of Professor Slaughter can be found on page 152 of the appendix.]

Chairman KANJORSKI. I have a few questions, and I am sure some of my colleagues will, as well.

First of all, let me thank all of you for appearing. I note the make up of the panel is not necessarily the individuals or nations that would be raising the question with the Congress or the American people as to who should be an investor, although we are very worried about Sweden's military intents against the United States. We are going to watch that very closely.

That is humorous, for those reporters who do not know.

[Laughter]

Chairman KANJORSKI. Or Norway, I should say. That is a real threat, Norway.

May I say one of the problems is this massive amount of funding and the idea of American corporations and international corporations. There are so many of our larger entities that have no nationality, and they happen to stop by to invest or do business.

But I would not call them a citizen of any particular nation, and probably the individual international companies are driven more from profit motive than anything else, and least driven by national interest, particularly the United States' national interest.

What do we do about it? While it is small, while it is identifiable and rather limited, as it is today, that is not really my thought process. It is what do we do over the next decade or two as these numbers severely run up.

Quite frankly, I am at a loss to know at what point we will lose control. An example I gave earlier with the last panel: What happens if we allow foreign equity to take control of our utility companies, whether it is electric utilities, gas utilities, or any form of energy, and there is a disagreement between the two nations?

I think we have to be less than serious to think there would not be a tendency to utilize those economic assets toward a strategic end for the national interest of the nation involved with the funds out there.

I remember the argument posed not too many years ago when the Administration was arguing to privatize Social Security. The question arose at that time and the argument was: Look how much more we could get if we invested in Wall Street. And why not instead of investing at 1.9 percent—I think that is the amount of transfer interest payment within the government—why not allow that to be invested by a trust or some entity in the market?

Very quickly, with the amount of funds we are talking about, all the equities on Wall Street would be owned by the Fund. It would be, I guess, the ultimate end to capitalists, by encouraging the supply of money to be provided by the government, it would literally become a truly socialist nation, since all the interests of equity would be sold out to funds of the government.

I thought it was a legitimate argument that you would not want Social Security funds directly used to purchase equity positions or control positions of American business or industry.

What is different in your estimation from that argument not to use Social Security funds to be invested in our equity markets and banks, etc., and foreign equity funds or sovereign funds, rather than being just in credit instruments, now going into equity instruments that determine policy and direction of corporations?

Let me throw that out to the panel.

Mr. SLAUGHTER. Mr. Chairman, I would offer a couple of reflections on your thoughts. One is that your point is well-taken. Governance, I think, is one of the issues of information that is important to think about, meaning both for privately owned and operated corporations and for various sovereign funds, the fact that they may be domiciled in one particular country leaves open the question of what are the linkages with the government of those countries as well.

There are a lot of different structures that could exist, and I think it is something for which information helps.

A second comment is your point is very well taken about your example of owning equities as part of the economic damage that can come when governments in some broad sense are in the business of helping run businesses. I will point out that the market offers a natural check against that, which is existing shareholders, existing boards of directors of privately held corporations recognize the potential limitation of a government from asserting managerial control over a corporation, and that is a natural check above and beyond what legitimate national security concerns there might be on those potential transactions.

Chairman KANJORSKI. When you have such things as sovereign funds and there is a violation of the law or regulations, who do you

identify as becoming the potential punishable party? How do you implement that punishment?

If you invest and commit a fraud or commit some act that violates the laws or regulations of the United States, we charge you. If you are found guilty, you pay the appropriate fine or incarceration.

How do we do it when it is a sovereign body? Do we invade?

Mr. SLAUGHTER. I am an economist, not a lawyer, so I am not quite sure of some of the important legal issues here, but I will point out that when I served on the Council of Economic Advisors, I served on CFIUS as one of the member agencies.

One of the important points about CFIUS was that CFIUS was there on top of existing protections that we may have from our financial regulators, for example, for the financial system, for national security interests. CFIUS operates as a backstop against a lot of existing U.S. law for when there might be a national security concern for any commercial transaction.

I will reiterate something I said in my testimony, if I may, which is that one of the important features of CFIUS, I think, that provides a measure of safety is the fact that CFIUS can address transactions at any time. It need not be before that transaction occurs.

Even after the fact, if a legitimate national security concern arises, CFIUS has purview over that.

Chairman KANJORSKI. I think I better recognize my friend from Texas. Ron?

Dr. PAUL. Thank you, Mr. Chairman. I just have a brief question for the panel, especially those who represent sovereign wealth funds.

From your viewpoint, how do you see our discussion? Do you worry about our discussion and what we might do? Is there something that we would do that would be harmful both to you and to us or can you quantify this problem?

Obviously, we see it as a problem because we are having hearings and we are discussing it and there is a lot of political talk about it.

Could any of you quantify it and say well, this is not as big a problem as you think or it is much bigger, if you do this, things are going to get much worse, it is going to be bad for us and bad for the United States?

Does anyone want to volunteer a comment along those lines?

Mr. ISRAEL. If I could, I believe from our perspective as an investor, we look to open markets which are well-regulated, which are efficient, which are competitive, and where capital can flow freely.

The concern that we would have as an investor is seeing the United States, or the world, if you will, lean towards protectionism out of a concern for this issue. We believe that would be damaging to our mutual interests in such respect.

Mr. SKANCKE. I do not think we are worried in the sense that we think there is a great risk that there will be restrictions on our investment activities as such with the profile that we have because we have purely financial investments, no strategic holdings.

With the investment strategy that we have, we do not assess the probability of restrictions; we do not see it to be very high.

However, of course, if there are restrictions put on, for instance, the use of voting rights in companies, even as a financial investor, of course, we have legitimate financial concerns, and the relationship between shareholders and boards where the managers are the agents and the board representing the shareholders is the principal, and of course, if you cut down that line of communication between shareholders and boards and do not have any possibility of making boards responsible, then we would see that this is a less attractive market because it would erode the confidence in the corporate governance part of the market.

I think further progress on accountability of corporate boards will probably give a positive effect on the attractiveness of the U.S. market.

Dr. PAUL. Mr. Denison?

Mr. DENISON. I would say in the public markets where our activity is primarily portfolio investments, relatively small investments in U.S. companies, it would not have any effect.

The potential effect is greater in the private markets, in private equity transactions, in private real estate, or in private infrastructure in this country, or in other countries.

We are an investor, where public policy has established that infrastructure, for instance, can be owned privately, and we are an interested investor in those kinds of assets. They are a natural match for a long horizon investor like us.

If there is a degree of uncertainty that has entered into how we will be viewed as a potential investor in those assets, that will potentially have an impact on how we view individual markets and where we would put our emphasis.

Dr. PAUL. Mr. Slaughter, how serious do you think this problem is? I know you have had testimony and addressed it to some degree. Is this a very serious problem we are facing and we have to deal with it, or could we overdo things?

Mr. SLAUGHTER. I believe the potential for overdoing things is there. I will come back to the point, you have talked about the ongoing U.S. current account deficits. That requires us on net every year to be selling several hundred billion dollars in assets to the rest of the world.

The attractiveness of our sets of assets compared to those in any of these other countries depends in part on the perceived policy environment that we set up for these potential investors.

I think in the near term, this is likely as long as the United States continues to have low national savings relative to the level of capital investment, we will need to continue financing that deficit through asset sales to the rest of the world.

I think that in broad context that is important to keep in mind in thinking about these important issues.

Dr. PAUL. Thank you.

Chairman KANJORSKI. The gentleman from Illinois.

Chairman GUTIERREZ. Thank you, Mr. Chairman.

Mr. Skancke, let me ask you a question. The funds that you control, who are the shareholders? People in Norway?

Mr. SKANCKE. Formally, the Fund is owned by the Ministry of Finance.

Chairman GUTIERREZ. By the government?

Mr. SKANCKE. By the government. It is managed by our Central Bank.

Chairman GUTIERREZ. Its purpose is to provide what?

Mr. SKANCKE. The purpose is really twofold. In the short term, the oil revenues are very volatile. We want to smooth them out. In the long term, we have to save—we have an aging population, and we have to save for the future.

Chairman GUTIERREZ. Mr. Denison, in that sense, they are saving up for their aging population. How about your Fund?

Mr. DENISON. Our Fund supports the pension promise behind the Canada Pension Plan, so it is for 17 million Canadians.

Chairman GUTIERREZ. Canadian people would be the shareholders in your Fund?

Mr. DENISON. The beneficiaries; yes.

Chairman GUTIERREZ. Mr. Israel, how does your Fund work?

Mr. ISRAEL. First, we are not a fund. We are a corporation.

Chairman GUTIERREZ. I am sorry; corporation.

Mr. ISRAEL. Which is an important point to us. Ultimately, if you will, our Ministry of Finance owns 100 percent of our corporation. However, I would suggest to you that the ultimate beneficiaries are the citizens of Singapore.

The dividend from our Fund flows to the government and is incorporated in the government budget as part of their investment income, which serves the people.

I think the greater purpose of the Fund ultimately is to build an endowment for the future for the citizens of Singapore.

Chairman GUTIERREZ. Does the government use the 18 percent return you have had over the last 20 years?

Mr. ISRAEL. The government historically has earned a dividend of 7 percent, which is a dividend recommended by the Board and approved by the shareholders in an annual meeting.

Chairman GUTIERREZ. The other 11 percent?

Mr. ISRAEL. The rest of the Fund accumulates and grows over the years. Today, it is $110 billion U.S. dollars. It is really an endowment for the future. I think you have to take into account our context. Singapore is a tiny island nation about the size of Lake Tahoe. We have no natural resources. We are not self-sufficient in water. We are not self sufficient in food.

We live in a volatile world with uncertain global markets and changing political and economic forces.

Our belief is that as a nation in such circumstances, we need to put something away for the future to deal with those uncertainties.

Chairman GUTIERREZ. Yes. I think that would be good advice for the United States of America, to put something away. Talk about an aging population; we have tens of millions of baby boomers. I think about 40 million of them, something like half of our workforce, is going to retire in the next 20 years.

I think we should not only look at your corporation or your funds, but start thinking about how strategically we are going to deal with tens of millions of people who are going to be retiring from our workforce in an unprecedented percentage, unprecedented in recent memory, at least economic history in the United States of America.

I am much more concerned obviously about what you do and how you go about doing it to see if we might not learn and incorporate some of what you do, so that as we look at our own aging population, we can make some decisions about how we are going to take care of them.

I thank Mr. Slaughter, an economist, for looking at that, and maybe in a subsequent meeting, because I only have a minute and 16 seconds left, we might look at this.

Actually, financial institutions in the United States do not encourage saving money. We reduce—the Fed Chairman keeps reducing the cost of money but actually the banks are charging even more for mortgages at a time of a mortgage crisis.

Here is money, it is cheaper. Charge the public more. When you walk into a financial institution and then our taxing system taxes it as ordinary income, if I invest in stocks, then I have capital gains tax. If I put money in a financial institution, in a savings account, then they charge me 2 to 3 times the same tax rate for saving money versus investing money because of course, my colleagues on the other side like to think about investing money, except in working class neighborhoods people tend to save, not invest in stocks and in equities.

Lastly, maybe from an economic point of view, I will write you a letter, and you can share some things that we might share with members of this committee about what we do.

The Norwegians are here saying we have extra oil. If you do not play by the rules, we will just keep the oil in the ground. It is only worth more next year than it was worth this year probably. It is not as though it is something that is losing value. They will just keep it there.

The Russians are doing the same thing. The comparison between the Euro and the dollar, why would not Germans and the rest of Europe want to come and buy us, especially when we are cheap, and the Middle East and their oil supplies, the Chinese.

We just put $150 billion out there to stimulate our economy. We are going to buy lots of Chinese goods at K-Mart and Wal-Mart, and then they are going to come back and do what, continue to buy bonds? I would not buy our bonds, especially if I have $400-plus billion of them. I would buy a stake in American companies, especially when we see the Chinese going about the world acquiring and making relationships with governments that help facilitate their industrial development and their relationship to natural resources.

Why not come to the United States of America and develop some of those natural resources?

We will be writing you a letter so that we can look at that. I think a greater danger to our economy is what we do, not what the rest of the world takes advantage of as we lack any strategic planning in our economy.

Thank you all, the panelists, for being here this afternoon.

Chairman KANJORSKI. Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman. I want to thank the panelists for being here also. It is very intriguing.

I think as the chairman indicated, probably those who are sitting at the table, not the ones that initially we were worried about, but

now that it is, you all are moving along quietly, nobody was bothering you or anything of that nature, and all of a sudden, because of the influx of money that has come in from some of the other areas, that quite honestly have been some of the trouble spots in the world and questions the integrity of what they are going to do or what are their purposes, is there an ulterior motive, I think that is what comes to bear here.

With that, any time you have anything or any question, even if you have good access, you have to figure out—everybody has to fit within these rules and figure out how we move forward.

I look at sovereign wealth funds probably as yet another example of the growth of capitalism and innovation in the global marketplace, because we are in another place than we were before, and we have to look at it and how we move forward.

I do believe this Congress should engage in a careful and balanced examination of this important issue and when and if we take action on the issue, what we should do and how we should do it in a manner that encourages growth while maintaining the global economic stability.

I think we are more interdependent upon one another economically whether we like it or not with countries that we may get along with or not now than we had ever before.

That being said, many of those of you sitting here and we look at your sovereign wealth funds, there seems to be some kind of transparency, issues that we can put our hands on, but others, we cannot say the same.

I think Mr. Slaughter, in your testimony, you state that the United States should continue to participate in ongoing multilateral dialogues with sovereign wealth funds to generate more and more transparent information from the funds.

My question to you would be what if there are certain funds that just refuse to comply with the reasonable standards of transparency and good governance?

How can we protect ourselves without running afoul of our WTO commitments and/or inviting retaliatory restrictions against U.S. investment?

I want that transparency, but somebody refuses. What do we do?

Mr. SLAUGHTER. That is a great question. Two things. One is my sense is in a lot of other international economic policy areas, discussion and deliberation tends to bring lots of parties around to recognizing that a set of best practices are in everybody's interest to follow.

I think there are parallels in international trade policy, for example, where some countries have had very different trade policy practices. They did not want to reveal certain things about how they settle anti-dumping rules, for example. There has been progress over time in many areas in international trade policy that I think are parallel here.

That requires having all parties to the table and having robust and candid discussions and again, my sense is the International Monetary Fund, the OECD and other organizations supported by our Treasury Department and others in our government are having those conversations. That is one thing.

I think the second thing again in that transition time as we are learning more about different sovereign funds, we have with CFIUS a sound process in the United States for addressing any legitimate national security concerns that might arise from any particular investment.

CFIUS has flexibility on many dimensions to allow us to have that certainty, and especially with reforms that the good bilateral discussion last year in Congress in the new legislation of FINSA, I think, strengthened a lot of CFIUS practices, and will make that going forward an even better process.

Mr. MEEKS. I see I am out of time almost already. You indicated in your testimony that CFIUS does not have a statute of limitations.

I was wondering whether or not if you knew of any time or how often it has happened that there has been a transaction that was reviewed by CFIUS and after it had already been closed, where they reviewed it again?

Mr. SLAUGHTER. I think that is unusual. Again, I think it speaks to the issue of all parties concerned having the incentive to participate in best practices.

I think on that particular question, oftentimes acquiring parties or target parties recognize the value in approaching CFIUS member agencies before the transaction to start a dialogue about it, because oftentimes, to the extent that there are legitimate national security concerns, they are addressed through various mitigation agreements that allow the transaction still to go forward, to achieve the commercial value that is desired, and yet still address whatever legitimate concerns there are.

I think there are examples in the past, but they are unusual after the transaction CFIUS investigation, but there is a parallel with the issue that you raised about the value of having robust discussion among all parties on best practices.

Mr. MEEKS. Mr. Chairman, if I could just ask Mr. Denison one quick question. I am just curious. He testified that the Canadian Pension Plan Investment Board Act can only be amended by a consensus of our federal government and at least two-thirds, I think he said, of the participating provinces representing two-thirds of the population.

I just want to know has an amendment ever been made or attempted? If so, what changes were made?

Mr. DENISON. Amendments have been made. They have all been at the suggestion of the CCP Investment Board itself, and they have been to deal with investment constraints which were originally imposed upon the investment organization and at our recommendation, we have asked for those to be lifted, and in all cases, we have achieved not just the two-thirds, but we have achieved unanimous consent.

There has not been any amendment, however, which has been initiated by either our federal government or any of our provincial governments.

Mr. MEEKS. Thank you. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Meeks.

We are going to wrap this up very shortly. I do want to ask the panel, you are individual nations. Do you have any constraints on

American investment or other nations' investment in your nations, any standards that they have to rise to or perform? How do you handle it? Are you all the same or are you different in that regard?

Mr. ISRAEL. Speaking on behalf of Singapore, Singapore maintains a very open market, a very efficient competitive and regulated market.

Chairman KANJORSKI. We could buy any corporation? The United States Government could buy any corporation in Singapore?

Mr. ISRAEL. You can invest in any corporation in Singapore.

Chairman KANJORSKI. We could invest. We could not have a controlling interest?

Mr. ISRAEL. It is no different than the United States in terms of it is a regulated industry. It would be subject to certain tests which are probably very similar to the tests that would be applied in the United States.

You have telecom regulators. You have banking regulators, etc. Insofar as one is in compliance, I believe you are free to invest.

Chairman KANJORSKI. There are some industries that have little or no regulation in the United States. Are there such organizations in Singapore?

Mr. ISRAEL. The parallels exist and you are free to invest.

Chairman KANJORSKI. How about in Norway?

Mr. SKANCKE. The situation is very much the same in Norway. We have had the pleasure of having a lot of American companies in our oil sector, for instance, over the years.

We have some sectors where there are regulations. Those are not really based on the nationality but they are based, for instance, in the financial sector. We want to have spread ownership. We do not want individual shareholders to own more than 10 percent of a bank, either below 10 percent or above 90 percent, I think, to make sure it is a true mother/daughter relationship in terms of the ownership or it is spread ownership to avoid contagions in the banking system.

Those are not non-discriminatory rules. They are applied equally to foreign and domestic investors. There are sectors where there are regulatory concerns and where those apply to foreign investors.

Chairman KANJORSKI. Are there any laws that apply particularly to foreign investment?

Mr. SKANCKE. No. We are a part of the European economic area which comprises the European Union countries, so there is a free movement to capital and we are not allowed to have any other rules than European Union countries have.

We do not have like a CFIUS process or anything equivalent to that.

Chairman KANJORSKI. In Canada?

Mr. DENISON. Generally, Canada is a very open market for foreign ownership. It does have some regulated industries, broadcasting, telecommunications, airlines, and financial services, where there are restrictions on the concentration of individual ownership and as well in some of those cases, a restriction on cumulative foreign ownership, which generally is about 50 percent.

Chairman KANJORSKI. I do not think your three nations are most representative. How about China, Russia, and some of these other

nations, do they have restrictions on foreign ownership? I would suspect that North Korea does.

Are there any nations in the world that have restrictions as opposed to either American, European, or other investment, sovereign nation fund type investments?

Mr. SLAUGHTER. Mr. Chairman, if I may, there are many countries around the world that maintain foreign direct investment restrictions in particular industries.

Many developing countries as part of their expansion of market reforms, in countries like China and India, in recent years, has been to pull back on many of those investment restrictions. That is a work in progress. Many of those developing countries still do maintain substantial restrictions. It is oftentimes on an industry-by-industry basis.

Chairman KANJORSKI. In your role as a professor, why would you not think it would be a wise thing for us to say there is a need for treaty arrangements to standardize and uniformize the use of capital anywhere in the world, so we are not mistreated or abused if we want to go into a nation, and then that nation could trade here.

If they do not agree to that international standard, then they are just going to be excluded.

Mr. SLAUGHTER. I think in principle, there are good arguments for multilateral discussions about investment restrictions and bringing those down, similar to trade barriers, multilateral trade discussions in the WTO.

I think in practice, efforts have been made over the years for these multilateral discussions. The have been very difficult, akin to the difficulties we see now in the World Trade Organization.

Chairman KANJORSKI. If we did that, would it not be highly likely that we would not have this theft of intellectual property that occurs, for instance, in China?

They seem to be immune from any way of forcing them to adhere to standards that would be acceptable in the rest of the world.

If they do it to intellectual property, are they not going to further their interest in doing other things?

Mr. SLAUGHTER. Multilateral discussions on investment might compliment the efforts that are there already in our trade negotiations, so we have the TRIPS in the WTO, and when China, for example, was seated to the WTO in 2001, they signed onto the intellectual property components of the WTO in TRIPS.

Your point is well-taken. That is a process. It is a work in progress. Even though in law countries like China implement those policies and try to enforce them, in practice, that can be difficult.

Chairman KANJORSKI. Rather than this committee taking some action to legalize or change or restrict or regulate sovereign wealth funds' investment in the United States, would it not be wiser for us to ask that a commission be established in the United States to determine what our best interests and national interests are, and then to reduce that to an international conference to determine whether or not we have uniformity in the world before we just allow this to happen?

Mr. SLAUGHTER. I believe those sorts of discussions are ongoing in the United States, as Under Secretary McCormick said in his testimony, the President last year issued an open economy state-

ment for the United States, reiterating our openness to international trade and investment in particular.

I think the value of that again, especially for our American-based companies, one important feature of the economy that is often underappreciated is our key global engaged companies, they serve foreign markets overwhelmingly through foreign direct investment, through sales of their affiliates rather than through their exports going out of the United States.

The most recent data we have on that is in 2005, the parents of U.S.-headquartered multinationals, they exported to the rest of the world about $450 billion in goods, but in that same year, through their affiliates, they sold in foreign markets almost $3 trillion worth of goods, through the affiliates that they have established through foreign direct investment.

For the competitiveness of the U.S. economy over the longer term and for our companies, open investment in the rest of the world is very, very important.

Chairman KANJORSKI. I think we have had our session here and everybody seems to have gone off to make foreign investments.

[Laughter]

Chairman KANJORSKI. The Chair notes that some Members may have additional questions for today's witnesses, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to any of today's witnesses and to place their responses in the record.

The panel is dismissed and this hearing is adjourned.

Thank you.

[Whereupon, at 5:36 p.m., the hearing was adjourned.]

# A P P E N D I X

March 5, 2008

**OPENING STATEMENT**

**RANKING MEMBER SPENCER BACHUS**

**"Foreign Government Investment in the U.S. Economy and Financial Sector"**

**March 5, 2008**

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Thank you, Mr. Chairman, for holding this timely hearing on the issue of Sovereign Wealth Funds.

The past few months have been an exceedingly challenging time for the U.S. economy and for the financial services industry in particular. During that period, we have seen extraordinary infusions of capital from Sovereign Wealth Funds into some of this country's largest banks, providing those institutions with an opportunity to shore up their capital reserves, and enhancing the safety and soundness of our financial system.

No one can disagree that the vitality of the financial services sector is crucial to this nation's continued economic growth. These recent capital infusions have given Sovereign Wealth Funds and the countries that administer them a vested interest in the continued health of the U.S. financial services industry and the U.S. economy. Like any other investor, Sovereign Wealth Funds expect their investments to succeed. It is in their economic self-interest that the U.S. industries in which they

have invested continue to grow. And it is in the interest of the U.S. economy to welcome this investment. Foreign investment — whether from a private investor who lives abroad, a publicly-listed company that trades on a foreign exchange, or from a Sovereign Wealth Fund — creates jobs here in the United States and fosters economic growth.

Nonetheless, there are important questions that we have to ask about the growth of Sovereign Wealth Funds. We must ensure that we have the policies in place that prevent this investment — however welcome it may be — from compromising our national security. We must ensure that Sovereign Wealth Funds play by the same rules that all large investors play by when they invest in U.S. companies. And we must ensure that Sovereign Wealth Funds do not pursue purely nationalist or strategic economic objectives at the expense of the U.S. companies in which they have invested.

We cannot forget that capital is more mobile than it has ever been in the history of the world, and that capital can and will travel anywhere. We must reserve the right to reject foreign investments that compromise our national security or place us at an economic disadvantage. But we must also avoid creating an investment climate that is hostile to legitimate foreign investment, for if we do, the world's capital will simply flow elsewhere — perhaps with much more serious and harmful long-term effects on our own economy. The key principles must be

transparency and fairness. And we should insist on equal treatment for U.S. investment, meaning that we should be able to invest in other countries in the same way they invest here.

To address the national security concerns that foreign investments potentially raise, Congress passed strong bipartisan legislation last year – written in this Committee
-- to reform the processes followed by the Committee on Foreign Investment in the United States (CFIUS). We established a thorough mechanism to review proposed investments for threats to national security, and to ensure greater government accountability in the approval process.

Mr. Chairman, while remaining vigilant to potential threats to our national security and our economy, our country must act responsibly to maintain an environment that is free and open to international investment, so that all Americans continue to benefit from inflows of foreign capital that create jobs and fuel economic growth here in the United States.

With that, Mr. Chairman, I yield back the balance of my time.

U.S. Congresswoman
Ginny Brown-Waite
*Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties*

Jt. DIMP and Capital Markets Committee Hearing
"Foreign Government Investment in the U.S. Economy and Financial Sector"
Wednesday, March 5, 2008
Statement for the Record

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Thank you Mr. Chairman for holding this hearing today. I am sorry I am unable to attend personally, but I am in Florida because of a family medical emergency. Please rest assured I have reviewed the testimony of the witnesses and will have staff fully brief me.

Mr. Chairman, too often Congress is criticized for being reactive instead of proactive. I regularly hear from constituents that many crises of the United States could have been avoided had Congress simply had the foresight to investigate before the problems began.

The meltdown in the subprime market is a prime example.

However, too often Congress also jumps the gun and gets over-involved in market processes through over-regulation and oversight.

The glitches still arising in Sarbanes-Oxley provide a different example.

This committee and its subcommittees have a duty to investigate sovereign wealth funds (SWFs) and their potential to dictate foreign and U.S. domestic policy. As they continue to grow in both size and prevalent use in foreign nations, like many Americans I grow concerned. Just today, the Washington Times published an article titled "Qatar seen bankrolling Hamas." This article stated that Palestinian leaders claim the government of Qatar provides millions of dollar each year to the people of Gaza, but terrorist Hamas leaders steal this money and use it for their own purposes.

What concerns me over these allegations is that Qatar is in the top 15 countries with the largest holders of foreign reserves. Qatar has one or more SWF, and held roughly $5 billion in U.S. debt in 2006. This represents a 346% increase in their holdings since 2001.

I am not alleging that the government of Qatar is using its SWF to fund Hamas; but this information represents a troubling quagmire for the United States and those who purchase our debt. I hope we work in sync and effectively with the International Monetary Fund,

the World Bank, and the Organization for Economic Operation and Development as they establish guidelines for SWF operations.

Again, thank Mr. Chairman for your foresight in holding this hearing, and I am sorry I was unable to attend.

**OPENING STATEMENT OF**
**CHAIRMAN PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**JOINT SUBCOMMITTEE HEARING ON "FOREIGN GOVERNMENT INVESTMENT IN THE U.S. ECONOMY AND FINANCIAL SECTOR"**

**MARCH 5, 2008**

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Good afternoon. We meet today at this joint hearing to learn more about foreign government investment in the United States. We will, in particular, focus on the tremendous growth of sovereign wealth fund investment in our economy. This hearing also represents the first time that sovereign wealth funds have appeared before a congressional committee.

Sovereign wealth funds currently maintain anywhere from $2 to $3.2 trillion in assets globally. By 2015, some estimate that this figure will reach $12 to $15 trillion. Since 2005, twelve sovereign wealth funds have been created, and approximately 40 such funds exist today. Over the last eleven months, sovereign wealth funds have additionally invested more than $69 billion in U.S. financial institutions. Because these funds are growing so rapidly both in number and in size, today's hearing comes not a moment too soon.

Currency reserves and profits from commodities are the two primary sources of revenue for sovereign wealth funds. So, the trade imbalances we have created, particularly with China, all but guarantee that growth in these funds will continue. Couple that reality with the record-high price of oil and the picture becomes even clearer: continued foreign investment in the U.S. economy is here for some time to come.

As we begin, I want to welcome our panelists who represent foreign government investors – including funds from Norway and Singapore, as well as Canada's pension board. We are pleased that you have stepped forward. Today, we can begin a dialogue with you, and hopefully other sovereign wealth funds will step forward in the future to do the same.

As we proceed today, everyone should understand how our actions contributed to the growth of sovereign wealth fund investment in the United States. We created the huge trade imbalances that bolster other governments' currency reserves and enable them to invest in our economy. Similarly, our dependence on foreign oil and our resistance to adopting a sustainable energy policy has made other governments rich with our dollars and allowed them to purchase shares in our companies. Finally, our national savings rate has been negative in recent years.

Although we created these market conditions, we must now take an active role in seeing to it that foreign governments invest with a fair degree of transparency, predictability, and good governance, and do so with an eye toward promoting economic interests as opposed to strategic or political goals.

Without question, we now live within a global economy, but the national security and national interests of the United States must always remain paramount. Governments generally act in their best interest. In considering our best interest, we cannot afford to assume that all foreign governments are merely rational economic actors, seeking to maximize profits. This principle may be true in many, or even most, cases. But governments have strategic interests, too. It is a geopolitical reality. The question becomes: Are they acting on those strategic interests when investing in American companies?

Merely asking questions here today does not make one a protectionist or an alarmist. Seeking to understand the operation of sovereign wealth funds does not make us fearful of or hostile to foreign governments. We are not overreacting by conducting this hearing, as some might want to suggest. Rather, we are opening an important conversation and fulfilling our constitutional duty to regulate foreign commerce.

Ultimately, we may decide that developments in this sector warrant the adoption of new laws or regulations. I want all of the witnesses to know that I have an open mind on these matters. Your comments today will help us to determine the best course of action going forward.

In closing, I look forward to hearing the panelists' thoughts on these matters. I want to thank each of them for appearing. Your views will assist us in understanding where we are and where we are going. We must find a way to promote efficient and viable capital markets in a global world, while safeguarding American sovereignty.

**COMMITTEE ON FINANCIAL SERVICES**
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

**Donald A. Manzullo (IL-16)**
**Opening Statement**

March 5, 2008

Mr. Chairman, thank you for holding this hearing today. It has been nearly a year since this Congress examined the impact of foreign investment in the United States, and that inquiry resulted in the enactment of the *Foreign Investment and National Security Act of 2007* (P.L. 110-49). That legislation positively reformed the oversight process of the Committee on Foreign Investment in the United States (CFIUS). I was pleased to be a part of that process that included my recommendation to have heightened scrutiny of sensitive transactions involving foreign state-owned enterprises. I look forward to the opportunity to again examine the significance of foreign investment in the U.S. economy, this time through the vehicles of sovereign wealth funds.

Before attempting to assess the pros and cons of sovereign wealth funds, it is important to examine the important role that foreign direct investment, including that provided by sovereign wealth funds, plays in the

U.S. economy. U.S. subsidiaries of foreign companies employ 5.1 million Americans, of which 31 percent are in the manufacturing sector; have a payroll of $325 billion; and account for 19 percent of all U.S. exported goods. Foreign direct investment, including sovereign wealth funds, provide capital to purchase companies in the U.S. where there may be no domestic financing available, thereby saving thousands of U.S. jobs. Foreign owned companies play a large role in retaining firms and jobs in the district that I represent, including Ingersoll Machine Milling (Italy) and Ingersoll Cutting Tools (Israel) in Rockford; Atlas Cold Storage in Belvidere (Canada); Nissan Forklift (Japan) in Marengo; Eisenmann Corporation (Germany) in Crystal Lake; and Cadbury-Schweppes (United Kingdom), which owns the Adams confectionary plant in Loves Park. In fact, Illinois is fifth in the United States in terms of the number of employees supported by U.S. subsidiaries of foreign companies per state.

On a macroeconomic level, the benefits of foreign direct investment translate into lower interest rates, increased employment, productivity, and overall increased financial stability. This has been evidenced recently by

the large cash infusions by sovereign wealth funds into financial firm such as Citigroup and Merrill Lynch, both of whom are struggling because of the current market turmoil. While some may question the political motivations of these sovereign wealth funds, the benefits of the liquidity they provide in a cash-strapped market is obvious.

Indeed, most sovereign wealth funds have proven they are beneficial vehicles for foreign investment. Norway, for example, is a close ally with transparent governance for its sovereign wealth fund, the second largest in the world. However, we must acknowledge that all sovereign wealth funds are not created equal. Sovereign wealth funds from China, the United Arab Emiratis, and Qatar are troublingly secretive.

Particular concerns have been raised by the recent actions of the Hong Kong-based subsidiary of China's sovereign wealth fund. In January, the Hong Kong-registered SAFE Investment Company surreptitiously purchased shares of three of Australia's largest banks. China repeatedly denied knowledge of the transactions or even of the

existence of the Hong Kong subsidiary before finally revealing that the Hong Kong investment company is a wholly-owned subsidiary, established in 1997. This quest for secrecy raises troubling realities about the opaque Chinese Investment Corporation. As a state-run enterprise, China's funds have access to cost free loans to finance purchases, giving them an advantage over private sector competitors. Second, China attempted this purchase—takeover, would be more accurate—on the sly, informing neither the Australian government nor the Australian banks of the intended nature of extent of their purchases. This raises concerns about the true character of these investment activities and the impact that this type of investment could have on market volatility.

These activities speak to the real need for increased transparency for sovereign wealth funds in the United States. International investment activities of governments should be based on stated policy objectives. Risk management structures should be in place and sound management of assets should be guaranteed. We must ensure that fair investment strategies are the standard, and that a foreign government is not using its

deep pockets to subsidize a company it owns, putting other potential private sector bidders at a distinct competitive disadvantage. While we must be careful to avoid the debilitating effects of protectionism, we must not allow a lack of transparency to undermine the efficiency of our market system.

Thank you, Mr. Chairman, for the opportunity to offer a statement. I look forward to hearing from the witnesses and continuing with the proceedings today.

Meeks

**Statement**

Chairman Gutierrez, Chairman Kanjorski, Ranking Members Pryce and Paul, Colleagues and assembled witnesses, good afternoon. I want to thank both Chairmen for calling this critically important and timely hearing on Foreign Government Investment in the U.S. Economy and Financial Sector. The explosive growth of foreign government investments, or Sovereign Wealth Funds has become a major focus of national and international economic and financial policy in the Congress and abroad.

The shear enormity of the investment funds presents both economic growth opportunities and challenges. According to some reports, estimates put the current size of the world's sovereign wealth funds at $2.5 trillion by the end of this year, with another $450 billion in transfers from reserves being added annually. Including capital appreciation, the amount could swell to $12 trillion by 2015. To put this figure into context, the value of the worlds hedge funds are thought to be $1.6 trillion.

While the current new growth of sovereign wealth funds has only recently caught the attention of this Congress, the funds are not new. The oldest and best example would be assets held by governments in foreign currency. All countries have foreign exchange reserves. When a country, by running a current account surplus, accumulates excess reserves, it can create a sovereign fund to manage those reserves. In fact, sovereign funds have existed since the 1950's, however, the worldwide growth has increased dramatically over the past 10–15 years. Presently, more than 20 countries have sovereign wealth funds and others are

expressing a desire to establish a fund. However, the top five funds account for about 70 percent of the total global assets and roughly half of these funds are controlled by countries that export significant amounts of oil and gas.

There's a lot that we do not know about sovereign funds. In fact, few publish information about their investment strategies, assets, or liabilities. However, it may be said that the managers of the world's central banks have begun to think in terms of how best to leverage the returns on the investment of their national treasure. Such a thought process and subsequent course of action is not unlike what an investment manager in New York does day in and day out, as they ask themselves, how they may best exercise their fiduciary responsibility to their clients of increasing the return on their clients investment.

Ultimately, sovereign wealth funds are yet another example of the growth of capitalism and innovation in the global market place. This Congress should engage in a careful and balanced examination of this important issue and when and if we take action on this issue we should do so in a manner that encourages growth, while maintaining global economic stability.

Again I look forward to receiving the testimony of our witnesses and to working with my colleagues on this issue.

# Opening Statement
# Ranking Member Deborah Pryce
# Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

## Hearing on Sovereign Wealth Funds

## Wednesday, March 05, 2008

Thank you, Mr. Chairman.

We are here today to discuss another issue tangentially connected to the sub-prime crisis.

In recent years, Sovereign Wealth Funds have grown dramatically in both size and scope, with investment today estimated at $2-3 trillion, growing to over $10 trillion in the next five years.

Nowhere has their importance been more evident than in the recent capital infusion of some of our largest banks – all told, nearly $70 billion in liquidity has been provided by Sovereign Wealth Funds as a result of the subprime crisis. In January alone, over $20 billion was invested by the governments of Kuwait, Singapore, and South Korea in Merrill Lynch and Citigroup.

While these investments are welcomed in helping to stabilize our markets, they have brought increased scrutiny on the structure and strategies of Sovereign Wealth Funds.

The concern lies primarily in the idea that investment funds controlled by foreign governments could be driven by political or national security strategies rather than purely economic.

The IMF and OECD are taking steps to develop best practices for investing countries, and those receiving investment. In discussions, the U.S. should support robust transparency standards which allow countries to accurately weigh national security concerns, while providing a clearly defined, level playing field for investing Funds.

The three Sovereign Wealth Funds before us today, controlling over $600 billion in assets, should stand as a model to other Funds: All three provide detailed information on both size of investments and portfolio composition.

I am hopeful that through oversight hearings like this and ongoing bilateral and multilateral conversations we can move towards a consensus which embraces similar openness and transparency for all Sovereign Wealth Funds.

Thoughtful conversation should help us avoid overreaction and protectionism.

In closing, I want to remind my colleagues of the primary goal stated in the CFIUS reform legislation we passed last year: to "ensure national security while promoting foreign investment and the creation and maintenance of jobs."

National security is paramount, but job creation and foreign investment are inseparable.

Thank you, Mr. Chairman – I look forward to the testimony.

For release on delivery
2:30 p.m. EST
March 5, 2008

Statement of

Scott G. Alvarez

General Counsel

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

and the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

of the

Committee on Financial Services

U.S. House of Representatives

March 5, 2008

Chairmen Gutierrez and Kanjorski, Ranking Members Paul and Pryce, and members of the Subcommittees, I am pleased to appear today to provide the Subcommittees with information on the standards for review by the Board of Governors of the Federal Reserve System of investments by sovereign wealth funds in banks and bank holding companies in the United States. The Board commends the Subcommittees for holding this hearing and for considering the important public policy implications raised by the recent investments of sovereign wealth funds in U.S. financial services companies.

As requested by your staff, I intend to focus my testimony on a narrow issue, the thresholds for review of sovereign wealth fund investments by the federal banking agencies and the current levels of investments by these funds in U.S. banking organizations and in foreign banking organizations with U.S. banking operations. I will begin with some general information about sovereign wealth funds and a summary of currently known investments by sovereign wealth funds in U.S. banks and bank holding companies. Then I will describe the relevant U.S. banking laws applicable to investments by sovereign wealth funds in banks and bank holding companies and the treatment under those laws of these funds by the Federal Reserve.

**Sovereign Wealth Funds**

Broadly speaking, a sovereign wealth fund is an investment fund that is owned by a national or state government. Globally, there are about thirty to forty sovereign wealth funds at this time. Many sovereign wealth funds were originally set up to help stabilize revenues from the sale of a commodity, such as oil, natural gas or other commodities. They also provide a way to preserve and grow wealth for future generations. Chile, Botswana and Kiribati have established sovereign wealth funds based on their revenues from the sales of copper, diamonds,

and phosphate. Examples of governments that have established funds using oil revenues include those of Norway, Kuwait, Qatar, and the state of Alaska.

Some developed nations have established sovereign wealth funds using social security or government pension fund surpluses and contributions from taxes and other government revenues. Such funds invest in a wide range of domestic and foreign assets with the aim of supplementing the future means of financing social security or government pension programs. Countries with this type of fund include France, Australia, and New Zealand. Other sovereign wealth funds have been established to make profitable use of foreign exchange accumulated as the result of trade imbalances or foreign exchange intervention. Countries with this type of fund include Singapore, Korea, and China.

To achieve their objective of preserving and growing wealth for future generations or of profiting from often temporary surpluses of foreign exchange, sovereign wealth funds--like any investment fund--seek to earn an appropriate risk-adjusted return on the funds that they invest. Sovereign wealth funds apply many of the same kinds of strategies that other investment funds apply. Some funds, such as Norway's, engage solely in making small portfolio investments--i.e., their equity investments are typically below 10 percent of the voting shares of a firm. Others, such as Singapore's Temasek Holdings (Temasek), take substantial stakes in firms in selected domestic and foreign industries.

One of the reasons that sovereign wealth funds have attracted more attention in the past year is their size. The largest funds are very large. For example, Norway's sovereign wealth fund reports total assets of over \$350 billion; China's fund and Singapore's two funds each manage assets of at least \$100 billion. This places sovereign wealth funds among the largest investment funds worldwide. However, while the estimated two to three trillion dollars

sovereign wealth funds manage exceeds the $1.4 trillion managed by hedge funds, it is far less than the over $50 trillion managed by insurance companies, pension funds, and other investment funds combined. Further, it is an even smaller fraction of global debt and equity securities, which exceed $100 trillion.

Another factor that has made sovereign wealth funds stand out in recent years has been their rapid growth. Estimates suggest that sovereign wealth funds have been growing at a remarkable pace in recent years, possibly quadrupling in size between 2003 and 2007. This rapid growth arises from the growth in revenues from the sale of oil and other commodities, following significant increases in commodities prices. It also arises from the rapid accumulation of foreign exchange reserves and persistent current account imbalances.

A third reason that sovereign wealth funds have attracted attention in the United States recently has been their investments in U.S. financial institutions, which is what I will talk about today.

**Investments of Sovereign Wealth Funds in U.S. Financial Services Companies**

Over the past several months, sovereign wealth funds have made direct investments totaling more than $24 billion in U.S. financial firms. These investments account for a significant portion of the total additional capital raised by these financial companies in this period. Sovereign wealth funds have been a beneficial source of capital for U.S. financial institutions.

The recent wave of sovereign wealth fund investments in U.S. financial institutions consists of noncontrolling investments below 10 percent (and often below 5 percent) of voting equity. For example, Citigroup recently received a capital infusion from the Kuwait Investment Authority (KIA), the Abu Dhabi Investment Authority (ADIA), and the Government of

Singapore Investment Corporation (GIC), one of Singapore's two sovereign investment funds. None of these funds acquired more than 10 percent of Citigroup's total equity. Three sovereign wealth funds, the Korea Investment Corporation (KIC), Temasek, and KIA, each made similar noncontrolling investments in convertible preferred stock in Merrill Lynch and Co. These are all passive investments that have not triggered formal review under U.S. banking law, as I will explain in a moment. The press releases from the financial institutions announcing each of these recent investments have generally emphasized that these sovereign investors will not seek to exercise control over the target company and will not have representation on the target company's board of directors or take part in its management.

**Thresholds for Federal Reserve Review**

As a general matter, the same statutory and regulatory thresholds for review by the federal banking agencies apply to investments by sovereign wealth funds as apply to investments by other domestic and foreign investors in U.S. banks and bank holding companies. These requirements are established in two federal statutes, the Bank Holding Company Act (BHC Act) and the Change in Bank Control Act (CIBC Act).[1] The BHC Act requires any company to obtain approval from the Federal Reserve before making a direct or indirect investment in a U.S. bank or bank holding company if the investment meets certain thresholds. In particular, the BHC Act requires Board review when a company acquires: (1) ownership or control of 25 percent or more of any class of voting securities of the bank or bank holding company, (2) control of the election of a majority of the board of directors of the bank or bank holding

[1] A third federal statute, the Savings and Loan Holding Company Act, governs investments in companies that control savings associations. The thresholds and standards for review of investments in savings associations established in that act are administered by the Office of Thrift Supervision and are nearly identical to those established by the BHC Act.

company, or (3) the ability to exercise a controlling influence over the management or policies of the bank or bank holding company.

In determining whether an investor may exercise a controlling influence over the management or policies of a U.S. bank or bank holding company for purposes of the BHC Act, the Board considers the size of the investment, the involvement of the investor in the management of the bank or bank holding company, any business relationships between the investor and the bank or bank holding company, and other relevant factors indicating an intent or ability to significantly influence the management or operations of the bank or bank holding company. The BHC Act presumes that an investor that controls less than 5 percent of the voting shares of a U.S. bank or bank holding company does not have a controlling influence over that bank or bank holding company, and the Board generally has not found that a controlling influence exists if the investment represents less than 10 percent of the bank or bank holding company's voting shares.

A company that meets any of these thresholds is called a "bank holding company" and, in addition to the prior approval process, is subject by statute to supervision by the Federal Reserve, including examination, reporting, and capital requirements, as well as to the Act's restrictions on the mixing of banking and commerce. Moreover, a company that makes an investment that causes it to be a bank holding company is subject to a prior review requirement at a lower threshold for any investments in additional banks or bank holding companies. If a company already controls one U.S. bank, the company is required by statute to obtain approval from the Federal Reserve prior to acquiring more than 5 percent of the voting shares of another U.S. bank or bank holding company.

There is one additional requirement governing the applicability of the BHC Act that is noteworthy. The BHC Act applies only to investments in banks and bank holding companies that are made by "companies." The Act specifically excludes investments made by the U.S. Government or by any state government. On this basis, the Board has long held that the provisions of the BHC Act do not apply to direct investments made by foreign governments.

The BHC Act also specifically excludes from its coverage any corporation controlled by the United States or by a state government. Thus, investment funds of the states of Alaska and New Jersey, for example, are specifically excluded from the requirements of the Act. As I will discuss in more detail below, the Board has not extended this exclusion to companies controlled by foreign governments that make investments in U.S. banks and bank holding companies. Foreign governments to date have primarily invested through sovereign wealth funds that are companies controlled by the foreign government. The effect of the Board's long-standing interpretation is that a sovereign wealth fund that seeks to make an investment in a U.S. bank or bank holding company that exceeds the thresholds in the BHC Act would be required to obtain Board approval prior to making the investment and would become subject to the other provisions of the BHC Act, but its parent foreign government would not.

Investments by sovereign wealth funds that do not trigger the requirements of the BHC Act may nevertheless require approval from a federal banking agency under the Change in Bank Control Act (CIBC Act). Prior approval from the Federal Reserve under the CIBC Act generally is required for any acquisition of 10 percent or more of any class of voting securities of a state member bank or bank holding company. Unlike the BHC Act, which imposes ongoing restrictions on the nonbanking activities of corporate owners of banks as well as ongoing

reporting, examination, capital, and other requirements, the CIBC Act does not impose any activity limitations or any ongoing supervisory requirements on owners of banks.

When an investor applies for the prior approval of the Federal Reserve to make an investment in a bank or bank holding company that triggers the review thresholds under the BHC Act or the CIBC Act, the Federal Reserve evaluates the application under the statutory requirements of those Acts. The BHC Act mandates that the Federal Reserve consider a number of factors when acting on BHC Act applications, including competitive, supervisory, and financial and managerial factors (the last including consideration of the competence, experience, and integrity of the officers, directors, and principal shareholders of the company or bank). The CIBC Act also requires the federal banking agency to consider specific factors, including competitive and informational standards as well as whether the transaction would jeopardize the financial stability of the bank, prejudice the interests of the depositors of the bank, or result in an adverse effect on the Deposit Insurance Fund.

Most sovereign wealth funds, like many other investors including U.S. investment banking firms, hedge funds, and private equity pools, have structured their investments so as not to trigger the thresholds for review and approval under either the BHC Act or the CIBC Act. Instead, sovereign wealth funds have limited their investments to amounts that represent less than 10 percent of the voting shares of the banking organization and have designed their investments to be passive and without the connections or relationships that might allow the sovereign wealth funds to control the U.S. banking organization.

**Investments of Sovereign Wealth Funds in Foreign Banking Organizations**

Several sovereign wealth funds, including some that have attracted attention with their recent investments in U.S. financial institutions, also have interests in foreign banks with U.S.

operations. The levels of ownership range from well below 10 percent to, in some cases, interests that indicate control of the foreign bank. These foreign banks generally conduct their U.S. banking operations through direct offices--branches and agencies; none controlled by a sovereign wealth fund currently controls a U.S. bank subsidiary. U.S. branches and agencies of foreign banks do not have all of the powers of U.S. bank branches. Specifically, U.S. branches of foreign banks are not permitted to accept retail deposits (deposits less than $100,000), except for a small number of grandfathered cases. Foreign bank agencies cannot accept deposits from citizens or residents of the United States. Funds with interests in foreign banks that operate U.S. branches and agencies include Temasek, GIC, China Investment Corporation (CIC), Central Huijin Investment Company (Huijin),[2] KIA, and ADIA.

After 1991, the International Banking Act (IBA) provided that any foreign bank seeking to establish a U.S. branch or agency must apply to the Federal Reserve for prior approval. All foreign banks controlled by sovereign wealth funds that have U.S. branches or agencies established those branches or agencies before the IBA was amended in 1991 to require Federal Reserve approval of the establishment by foreign banks of new U.S. branches and agencies.[3] Any future applications by foreign banks controlled by sovereign wealth funds to establish U.S. branches and agencies would be evaluated by the Federal Reserve pursuant to the standards

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[2] Huijin, a Chinese company with a mandate to improve corporate governance and initiate reforms in the state-owned financial sector, was created to act as a government holding company for Chinese state-owned banks acquired as a result of capital injections by the Chinese government. Huijin is expected to be acquired by CIC in the near future.

[3] Huijin acquired its controlling interest in one foreign bank, Bank of China, after the IBA was amended, but also after the establishment of Bank of China's U.S. branches. When a company makes a controlling investment in a foreign bank that already has U.S. branches or agencies, under Federal Reserve regulations the foreign bank is required to notify the Federal Reserve within ten days of the investment and report the shareholding in annual filings with the Federal Reserve.

in the IBA. An important factor the Federal Reserve is required to consider under the IBA is whether the foreign bank is supervised on a comprehensive consolidated basis by its home country supervisor. The Federal Reserve also examines how the supervisor monitors relationships and transactions between the foreign bank and any related party, including controlling sovereign wealth funds and other controlling shareholders. A number of additional factors are also considered, including the anti-money laundering regime of the foreign bank and its supervisor, the consent of the appropriate home country authorities, the financial and managerial resources of the foreign bank, and whether the foreign bank and any controlling company (including any controlling sovereign wealth fund) have made adequate assurances concerning provision of information to the Federal Reserve about its operations and activities.

**The Federal Reserve's Approach to Foreign Government Ownership**

As I noted above, the Federal Reserve has drawn a distinction between foreign governments themselves, which are not treated as "companies" subject to the BHC Act, and government-owned entities such as sovereign wealth funds, which are treated as companies and are subject to the BHC Act.

The position that the BHC Act does not apply to foreign governments themselves is long held by the Board.[4] It noted this view and revisited the reasons for this position in 1982 in connection with an application by an Italian government-owned bank to acquire a controlling interest in a U.S. bank.[5] At that time, the Board reiterated its view that the BHC Act should not be applied to the Italian Government. At the same time, the Board noted that significant policy

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[4] Governor John P. LaWare discussed this position and other issues related to foreign government ownership of foreign banks operating in the United States in testimony before the House Committee on Banking, Finance and Urban Affairs in 1992. 78 Federal Reserve Bulletin 495 (1992).

[5] Banca Commerciale Italiana, 68 Federal Reserve Bulletin 423 (1982).

issues were raised by foreign government ownership of a U.S. bank, including in particular issues related to the mixing of banking and commerce and to interstate banking in the United States (which was largely prohibited at the time). The Board invited Congress to address the issue and noted that the concept of national treatment could justify applying the BHC Act to foreign government-owned entities.[6]

In 1988, an Italian bank controlled by the Italian Government again applied to the Federal Reserve to acquire a U.S. bank. The Board carefully considered the applicability of the BHC Act to foreign governments and foreign government-owned entities and reiterated its earlier conclusion that, as a legal matter, foreign governments were not themselves "companies" for purposes of the BHC Act and were therefore not covered by the Act. The Board found, however, that the investment fund controlled by the Italian Government, the Istituto per la Ricostruzione Industriale (IRI), was structured as a corporate vehicle and was therefore a company under the Act and subject to the Act.[7]

At the same time, the Board indicated its willingness to grant exemptions from the nonbanking restrictions in the BHC Act to IRI for its commercial investments, citing IRI's status as a nonoperating instrumentality for holding government interests. The Board also expressed its willingness to exempt from the BHC Act the nonbanking investments of other foreign government-owned companies of a character similar to that of IRI, as long as their foreign bank subsidiaries conducted banking in the United States only through branches and agencies and not

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[6] Later in 1982, a subcommittee of the House Committee on Government Operations held hearings on foreign government and foreign investor control of U.S. banks. *Hearing on Foreign Government and Foreign Investor Control of U.S. Banks, before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations*, 97 Cong. 2 Sess. (Government Printing Office, 1982). No legislation, however, was proposed.

[7] Letter from William W. Wiles, Secretary of the Board, to Patricia S. Skigen (August 19, 1988).

through U.S. subsidiary banks. This approach limited the extraterritorial effects of U.S. economic regulation on foreign companies, in recognition of the fact that foreign countries may choose to organize their economies differently from the United States. It also kept the United States open to a significant number of foreign banking organizations whose U.S. banking activities might otherwise have been severely curtailed. Notwithstanding the availability of this exemption for government-owned companies (including sovereign wealth funds) that control foreign banks with U.S. banking operations, the foreign banks themselves are subject to the same degree of U.S. regulation and supervision as other foreign banks.

**Regulation of Bank Holding Companies**

Since a sovereign wealth fund is a company for purposes of the BHC Act, if a fund were to acquire control of a U.S. bank or bank holding company, it would be treated as a bank holding company and would be subject to the U.S. regulatory regime applicable to such companies. This regime is designed in significant part to help ensure the safety and soundness of U.S. bank subsidiaries of bank holding companies. Among the most important tools that U.S. bank regulators have to protect the safety and soundness of U.S. banks are the legal restrictions that limit the ability of a bank to lend to affiliates. Section 23A of the Federal Reserve Act provides that a bank may not lend more than 10 percent of its capital to any one affiliate or more than 20 percent of its capital to all affiliates combined. Of equal importance, any loan to an affiliate must be either fully collateralized by cash or U.S. Treasury securities or overcollateralized by 10 to 30 percent, depending on the type of asset or instrument used to secure the loan. Section 23A also prohibits the purchase of low-quality assets by a U.S. bank from its affiliates. Section 23B of the Federal Reserve Act requires that all transactions between a bank and its affiliates be

conducted only on an arms-length basis. These restrictions are designed to limit the ability of an owner of a bank to exploit the bank for the benefit of the rest of the organization.

With respect to a U.S. bank or bank holding company that might be owned by a sovereign wealth fund, these same restrictions would apply to transactions by the bank with the sovereign wealth fund itself and other companies controlled by the fund. Moreover, the restrictions would apply to companies controlled by the same government through other sovereign wealth funds of that government. Thus, a U.S. bank controlled by a sovereign wealth fund would not be permitted to fund substantially the operations of other companies controlled by the same sovereign wealth fund or its government owner, could not provide any uncollateralized loans to such companies, and could not purchase low-quality assets from those companies. In this regard, it would be important for any U.S. bank that might come to be controlled by a sovereign wealth fund to have information on which companies are controlled by the fund and by the government that owns the fund. This type of transparency would be necessary to allow the bank to comply with the affiliate transaction restrictions of sections 23A and 23B.

**Conclusion**

Recent sovereign wealth fund investments in U.S. banking and financial services organizations have attracted much attention and there is no doubt that sovereign wealth funds are growing in size and number and are making increasingly significant investments in financial services organizations worldwide. But foreign government-owned entities, including sovereign wealth funds, have owned foreign banks with U.S. operations for many years. The Board has long taken the position that while foreign governments themselves are not companies subject to the BHC Act, foreign government-owned corporations such as sovereign wealth funds are

companies. Thus any proposed controlling investment in a U.S. bank or bank holding company by a sovereign wealth fund would be subject to Federal Reserve approval.

Sovereign wealth funds, like private investment funds, U.S. state investment vehicles, hedge funds, and many other investors, have generally made investments at levels that are not large enough to trigger the thresholds for review and approval by the federal banking agencies under the federal banking laws. If a sovereign wealth fund were to make an investment in a U.S. banking organization that triggers one of these thresholds, the application would be evaluated by the Federal Reserve or other appropriate federal banking agency under the relevant statutes with no preference or handicap relative to other investors. Any sovereign wealth fund controlling a U.S. bank or bank holding company would be required to operate subject to the limitations on affiliate transactions in sections 23A and 23B of the Federal Reserve Act.

I appreciate the opportunity to explain these issues to the Subcommittees.

CPP
INVESTMENT
BOARD

**Written Statement of the**
**Canada Pension Plan Investment Board (CPPIB)**

**before the**

**House Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, and Subcommittee on Domestic and International Monetary Policy, Trade, and Technology**

**March 5, 2008**

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## The Canada Pension Plan Investment Board

### I. Introduction to CPPIB

The Canada Pension Plan Investment Board ("CPPIB") is an asset management organization that was created by Federal Act of Parliament in December 1997 (the *Canada Pension Plan Investment Board Act*) as an independent entity to invest and maximize the rate of return on the assets of the Canada Pension Plan ("CPP") without undue risk of loss. The CPP is a mandatory contributory defined benefit pension plan operated for the benefit of over 17 million Canadian contributors and beneficiaries. All Canadian employers and employees, except for those in the Province of Québec, make mandatory contributions to the CPP. CPPIB's assets were valued at C$119.4 billion (or US$121.1 billion) as of December 31, 2007, and are projected to grow to over C$312 billion by 2019.

The CPPIB is not a government-controlled entity. Although the CPPIB was created and is owned by the Canadian Federal government, its governance structure was carefully designed to prevent political interference. Our founding legislation specifies that we operate at arm's length from governments, and in accordance with a legislated investment-only, fiduciary mandate. Our investment decisions are not influenced by government direction, regional, social or economic development considerations, or any other non-investment objectives. Independent directors are appointed for three year terms, which can be renewed twice, and can only be removed for cause. We accompany our observance of these features with a high degree of transparency, much of which is also mandated by our legislation, including reporting to the public like a Canadian public company. CPPIB is not a sovereign wealth fund, and instead is internationally recognized for its independence from government influence.[1]

### II. Canada's Retirement Income System

Canadians' retirement security is based on three key elements: the Old Age Security (OAS) program, the CPP and tax-deferred private savings.

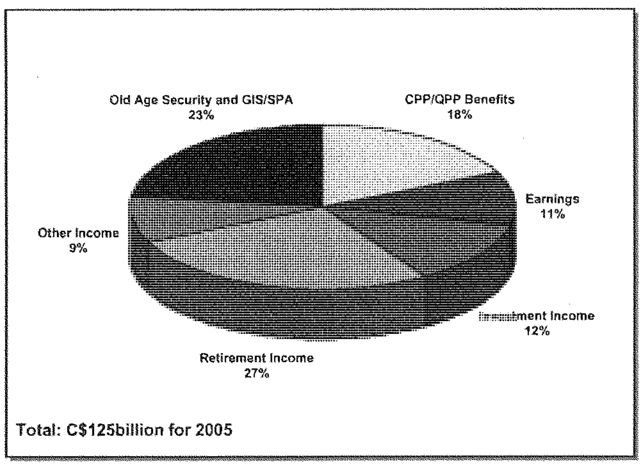
- Old Age Security (including the Guaranteed Income Supplement (GIS)) provides a minimum income for seniors, regardless of work history. It is publicly funded from government revenue.

- The CPP is a defined plan providing pension disability and survivor benefits. It is funded by mandatory contributions made jointly by working Canadians and their employers. The CPPIB invests contributions not immediately required to pay benefits; the CPPIB has no role in the Old Age Security Program. CPP funding is not part of general government revenues.

[1] See Directorate for Financial and Enterprise Affairs, Insurance and Private Pensions Committee, Working Party on Private Pensions, *OECD Seminar on Sovereign and Public Pension Reserve Funds – Sovereign Wealth & Pension Reserve Fund Issues*, copy of draft (subject to further revision) attached, at paras. 5.2(i) and 40. See also the notes for remarks by Gail Cook-Bennett, Chair of CPPIB, copy attached.

- Employer-sponsored pension plans (where offered) and individual tax-sheltered retirement investment accounts represent two examples of tax-deferred private savings.

Sources of Retirement Income in Canada




Source: Canada Revenue Agency Statistics for years 1999 to 2005

**III. About the Canada Pension Plan (CPP)**

The CPP was established in 1966 as a 'pay-as-you-go' plan funded by compulsory contributions made jointly by employees (including the self-employed) and employers, and is administered by the federal government on behalf of nine Canadian provinces. The current contribution rate is 9.9% of earnings to a yearly maximum income (C$44,900 in 2008). Revenues and expenditures for the plan are segregated from general government accounts, and the sponsors of the plan, Canada's federal and provincial governments, have no liability for the plan's funding.

The CPP retirement benefit is modest (maximum available in 2008 is C$10,614/year) and, as noted above, was designed to be one component of Canadians' retirement income. Retirement benefits comprise approximately 70% of plan expenditures; disability, survivor and children's benefits, and a lump-sum death benefit to the estate are also paid.

## IV. CPP Reforms

In 1996, the CPP paid out more in benefits (C$17 billion) than it received in contributions (C$11 billion). An actuarial report projected the plan's small contingency reserve would be exhausted by 2015. It predicted that a contribution rate of more than 14% would be necessary by 2030, effectively forcing future generations to fund current pension obligations.

Contributing factors driving change included:

- Changing demographics (aging of the baby boom generation);
- A succession of benefit enhancements;
- Slow growth of investment earnings from the fund; and slow growth in contributory earnings; and
- Higher benefit payments for disabilities.

In February, 1997, the provinces and the Federal government reached agreement on major reforms to the CPP, based on the following key steps:

- Modest reductions in future benefits;
- Change from 'pay-as-you-go' model to partial pre-funding with an accelerated increase in the contribution rate from 5.6 to 9.9 per cent in six years– an increase of almost 80 per cent in less than half the original timetable – in order to create a sizeable reserve fund;
- The creation of the Canada Pension Plan Investment Board to manage this fund for the benefit of over 17 million Canadian contributors and beneficiaries; and
- Segregation of the CPP assets from government assets and revenues.

## V. CPPIB Governance

The CPP reforms of the mid-1990s were the result of an intensive public consultation process undertaken by the Federal and Provincial governments.

Through this process, Canadians made it clear that while they were willing to accept a higher contribution rate, they were distrustful of leaving their pension funds under political control. Plan participants felt that government influence on investment decision-

making could lead to poor investment performance, and that they would suffer the consequences through higher contribution rates and/or lower benefits.

Since they were bearing the ultimate risk of higher contributions or lower benefits, Canadians set out the terms of the fundamental risk-sharing arrangement, as follows: They would consent to the benefit reductions and the contribution increases, provided that government would consent to a governance model that provided for a professional investment organization operating at arm's length, according to a purely fiduciary-driven commercial mandate.

This was the defining moment in the reforms of the CPP and the creation of the governance model for the CPP Investment Board.

Ensuring that the investment process remained at arm's length and independent from governments became an essential and closely scrutinized feature of the CPPIB governance structure.

This independence was then balanced against the need for sufficient accountability to governments – which are the effective agents of the CPP participants - to allow people to determine if CPP assets are being profitably and prudently managed for the exclusive benefit of plan participants.

To this end, the reformers created a "maximum-strength" governance model designed to strike a balance between independence and accountability, and they gave CPPIB a clear and singular mandate to achieve a "maximize rate of return without undue risk of loss."

The CPPIB's distinct governance model balances its arm's length relationship with governments with strong public accountability. The model is set out in *The Canada Pension Plan Investment Board Act*, which is the legislation governing the CPPIB.

**Amending Formula**

As an indication of the lengths pursued by the reformers to protect the CPPIB from political interference, this law includes an extraordinary provision. It can only be amended by a consensus of the Federal government and *at least* two-thirds of the participating provinces representing two-thirds of the population. This is an even higher level of consensus than that required to amend Canada's Constitution.

**Independence from Government**

The independence of the Board of Directors from government is an important feature of the CPPIB. Following are some of the key features of the CPPIB governance model:

- Management of the CPPIB reports not to government but to an independent board

of highly qualified directors.

- Directors of the CPPIB are selected by the Federal government, in consultation with participating Provincial governments, from a list of qualified candidates provided by a joint Federal-Provincial nominating committee with private-sector involvement.

- As required by the CPPIB Act, the nominating process is designed to ensure that the board has directors with proven financial ability or relevant work experience so that the CPPIB will be able to effectively achieve its investment mission including overseeing a growing and complex organization with approximately $120 billion in assets under management.

- The board of directors, not government, approves investment policies, determines with management the organization's strategic direction and makes critical operational decisions such as hiring the Chief Executive Officer and determining executive compensation.

- The CEO, in turn, hires and leads the management team, including the investment professionals who make portfolio decisions within investment policies agreed to by the board of directors.

- The composition of the board and the amending formula for the legislation keep the operations of the CPPIB independent from the actions of government.

- A stringent code of conduct stipulates that any attempts by government to influence our investment decisions, hiring practices or procurement must be appropriately escalated within the organization in order to determine what appropriate action should be taken.

To be clear, the CPPIB does not submit its investment strategy or business plans for government approval; does not have government officials sitting on its board; and does not submit its compensation policies or pay levels for government approval.

**VI. Public Accountability through Transparency**

The CPPIB's governing legislation requires a high level of transparency to help ensure public accountability. The legislation mandates quarterly detailed public reporting and the production of our annual report which is tabled in the Federal Parliament. This legislation also imposes a duty on the CPPIB to hold public meetings every two years in all nine participating provinces, and to open its books for a routine special examination every six years.

The CPPIB's board and management have voluntarily raised transparency to an even higher level by adopting a disclosure policy which states:

> *"Canadians have the right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf, and how the investments are performing."*

In keeping with this policy, the CPPIB reports its results on the same basis as most Canadian public companies, including the presentation of independently audited financial statements, as well as the inclusion of a Management's Discussion and Analysis and a Compensation Discussion and Analysis, in the annual report.

In addition, the CPPIB posts its investment policy and objectives, as well as a full list of its public equity holdings, on its website. The website also identifies the CPPIB's private investment fund partners and real estate fund partners, how much it has committed to each of these funds, and how much has been drawn down.

The CPPIB believes it is possible to provide a very high degree of transparency without compromising our proprietary investment insights.

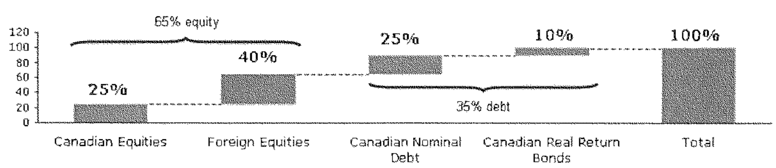
**VII. Investment Strategy & Accountability Framework**

The CPPIB's legislated mandate directs it to achieve "a maximum rate of return without undue risk of loss, having regard to the factors that may affect the funding of the CPP and the ability to meet its financial obligations on any business day." The CPPIB has interpreted this to mean that its mission is to generate the returns required to help keep the CPP sustainable over the long term.

In defining sustainability, the Federal and Provincial finance ministers who serve as the CPP stewards expressed a desire that the CPP be able to pay benefits at current levels, adjusted for inflation, with an employer-employee contribution rate of no more than 9.9 per cent. A 9.9 per cent contribution rate requires an annualized real return of at least 4.2 per cent over the 75-year projection period used in the *21st Actuarial Report on the Canada Pension Plan* that was prepared by the Chief Actuary of Canada.

Within those broad parameters of sustainability, the mission of the CPP Investment Board is to earn value-added returns over the long term to help secure the future CPP benefits of generations of Canadians. To measure investment management performance in relation to the long-term 4.2 per cent annual real return assumption, the CPPIB developed the CPP Reference Portfolio in fiscal 2006 and implemented it in fiscal 2007.

**Composition of the CPP Reference Portfolio**




The CPP Reference Portfolio is a potential strategic alternative for the CPPIB. It acts as a low-cost, low-complexity model portfolio that embodies the investment objectives and implied level of risk envisioned by the CPP stewards during the CPP reforms in 1997.

The objective in creating this hypothetical portfolio was to create a diversified, investable benchmark that is easily understood and reasonably expected to generate the long-term returns assumed in the Chief Actuary's 75-year CPP projection.

Since it is an investable portfolio, the CPP Reference Portfolio represents a valid strategic option for the CPPIB to fulfill its mandate. As such, it acts as a relevant benchmark by which to judge the performance of the CPP Fund as managed by the investment professionals of the CPP Investment Board. The CPP Reference Portfolio was created for accountability and measurement purposes only; it is not a target portfolio for the actual CPP Fund.

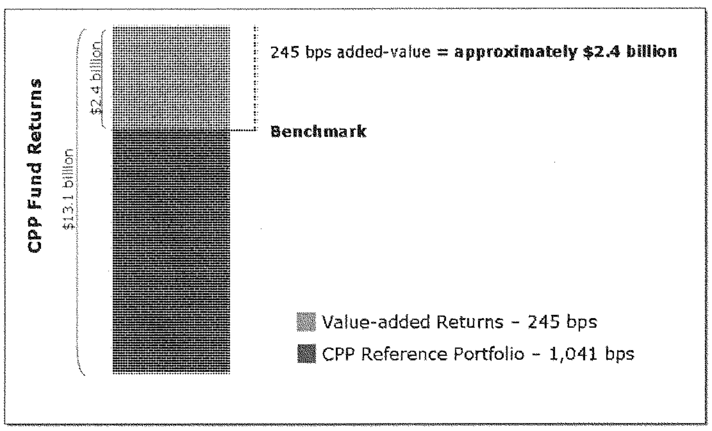
The CPP Reference Portfolio is the cornerstone of the Risk-Return Accountability Framework that supports our investment strategy and provides a clear method to measure our success. While the CPP Reference Portfolio could meet the long-term funding needs of the CPP based on the reasonable capital market returns assumed in its design, the CPPIB has made a strategic choice to strive to generate additional returns above those inherent in the CPP Reference Portfolio. Our investment strategy, therefore, is to add value above and beyond this strategic benchmark. Enhanced long-term returns improve the financial performance of the overall plan and thus contribute to the long-term sustainability of the CPP.

The range of investment strategies used in managing the CPP Fund has evolved over time. When the CPPIB began its investment program in 1999, cash flows were initially invested in public equities. This portion of the fund now holds shares of some 2,600 public companies, including 700 in Canada, largely as a result of replicating the composition of major stock markets.

In recent years, management has elected to pursue value-added returns by expanding the range of investment programs to include private equity, real estate and infrastructure, achieving greater global diversification and implementing a variety of active investment strategies.

The CPPIB's value-added performance target for fiscal 2007 was set at 35 basis points over the CPP Reference Portfolio return, taking into account the stage of development of our active investment capabilities. Actual performance for fiscal 2007 exceeded the CPP Reference Portfolio by 245 basis points (see chart below).

2007 CPP fund value-added returns




Investing an increasing proportion of the CPP Fund in global markets is part of our diversification and risk management approach. As the portfolio continues to grow, over time, the proportion of our portfolio invested abroad will increase. Investing in international markets supports our mission in three primary ways.

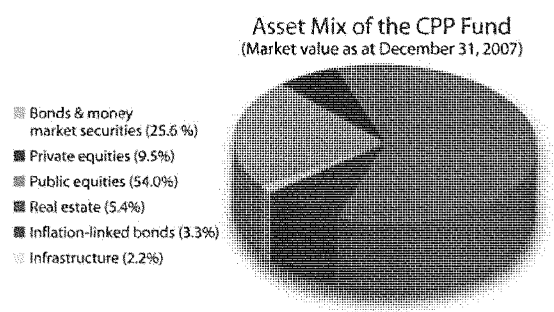
- First, Canada's marketplace is small relative to many other countries. For example, our stock market represents only 3 per cent of world market capitalization, and is heavily concentrated in a few sectors, such as natural resources and financial services. It offers few opportunities to invest in sectors such as technology, health care and consumer goods.

- Second, the flow of contributions into the CPP varies directly with the health of the Canadian economy. By reducing the Fund's reliance on the Canadian economy, global diversification offers a source of returns for those times when the Canadian economy, and correspondingly CPP contributions, is in decline.

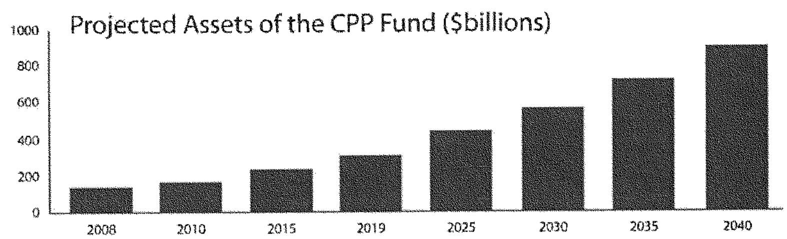
- Third, prudent investments in rapidly growing regions will enable the CPP Investment Board to harness the positive demographic growth and rising productivity of other regions of the world to create a flow of foreign income to help support pensions for Canadians. So, while maintaining a sizeable total investment in Canada, we are increasing the percentage of the CPP Fund's global investments.

### VIII. CPPIB Performance and Sustainability of the CPP

The CPP Investment Board invests the funds not currently needed by the CPP to pay benefits. The CPP Investment Board has built a diversified portfolio of marketable securities including public equity and private equity, fixed income, real estate and infrastructure.




The CPP is sustainable for the long-term. According to Canada's Chief Actuary, the CPP Fund is projected to have approximately C$312 billion under management by 2019. The first investment earnings from the plan are not expected to be required to pay benefits until 2020. Even by 2040, only one third of investment income will be needed to help pay pensions. The current 9.9% contribution rate is adequate to sustain the plan for the 75 years of the Chief Actuary's review period. An average annual real rate of return for plan investments must be at least 4.2% to sustain predicted expenditures; the annualized rate of return for the past four fiscal years is 13.6%. For the same four-year period, the real (e.g., after inflation) rate of return for the Fund is 11.7%.




The Office of the Chief Actuary of Canada ranks the CPP among the most securely financed plans in OECD countries with Norway, Sweden, the Netherlands and Australia. It is also probably the top plan among G7 nations. Even with the surge in retirements expected in the next decade, the CPPIB will administer one of the largest and fastest-growing single-purpose pools of investment capital in the world. That makes the CPP one of the most actuarially sound plans of its kind.

The following table summarizes financial performance of the CPP Fund managed by the CPPIB since 2000.

**Annual Fiscal Year Summaries**

| CPP Reserve Fund | FYTD 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|---|---|---|---|
| Total assets (C$billions) | 119.4 | 116.6 | 98.0 | 81.3 | 70.5 | 55.6 | 53.6 | 48.7 | 44.5 |
| Asset Growth (C$billions) | 2.8 | 18.6 | 16.7 | 10.8 | 14.9 | 2.0 | 4.9 | 4.2 | -0.2 |
| Portfolio returns (%) | 0.5 | 12.9 | 15.5 | 8.5 | 17.6 | -1.5 | 4.0 | 7.0 | 3.2 |
| Investment Income (C$billions) | 0.6 | 13.1 | 13.1 | 6.3 | 10.3 | -1.1 | 2.3 | 3.0 | 1.1 |
| Net CPP contributions (C$billions) | 2.2 | 5.5 | 3.6 | 4.5 | 4.6 | 3.1 | 2.6 | 1.2 | -1.3 |

**IX. CPPIB vs. Sovereign Wealth Funds**

The CPPIB is not a Sovereign Wealth Fund (SWF). There are at least four key attributes that distinguish it from SWFs and other forms of state-sponsored funds.

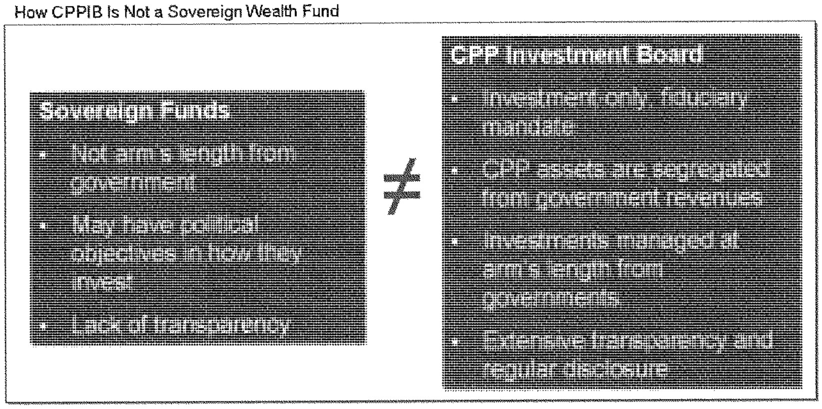
- Governance structure. The CPP Investment Board's governance model was designed to prevent political interference and is enshrined in the Canada Pension Plan Investment Board Act.
- An investment-only, fiduciary mandate. By design, CPP Investment Board decisions are economically motivated, commercial in nature and not influenced

by government direction, regional, social or economic development considerations, or any other non-investment objectives.

- Transparency. The CPPIB has set a high standard for transparency among public pension plans and, indeed, for investment organizations of all kinds.

- Segregated Assets. Unlike sovereign funds, Canada Pension Plan assets are not government assets and are not dependent on tax revenues. The Canadian government is neither a sponsor nor guarantor of the plan. While the CPPIB may share similar characteristics with other national pension funds, there are some important and significant differences between it and a Sovereign Pension Fund. The CPP is based on a sustainable model that takes into account the long-term liabilities of the plan, and by design, does not require 'top-ups' from government tax revenues to help sustain the pension fund.

How CPPIB Is Not a Sovereign Wealth Fund




**X. Foreign Investment and National Security Act (2007)**

The CPPIB is an active investor outside of Canada. As of September 30, 2007, more than 44.6% of our asset value was invested outside of the country. This foreign investment includes both publicly traded stocks and private companies, and infrastructure and real estate investments.

Almost half (approximately US$26.1 billion) of this foreign investment is in the United States, including investments in publicly traded stocks, private companies, infrastructure and real estate. Consequently, CPPIB has a keen interest in the opportunities for foreign investment and, more specifically, any negative effect that the US Foreign Investment

and National Security Act of 2007 (FINSA) will have on our ability to invest in the United States.

The US FINSA strikes an appropriate balance between, on the one hand, the clear benefits from foreign investment in creating jobs and raising productivity and the standard of living and, on the other, the unquestionable need for the United States to fully carry out its national security mandate. As FINSA is implemented, however, it is important to avoid negatively affecting the ability of non-government controlled investment organizations like CPPIB to complete US investments where there is no countervailing national security benefit.

**Defining "Government-Controlled"**

In this regard, CPPIB believes it is of utmost importance that entities like CPPIB not be considered foreign government-controlled for FINSA purposes. Foreign government-controlled transactions receive heightened scrutiny by the Committee on Foreign Investment in the United States (CFIUS). Specifically, they are subject to mandatory second-stage, 45-day national security investigations. Such transactions, therefore, face the prospect of the first stage 30-day review and mandated second stage investigation for a total period under CFIUS examination of 75 days. While the Secretary of the Treasury and the head of the lead agency are empowered to exempt such a transaction from the second stage investigation if they jointly determine that it will not impair the security of the United States, the starting point for foreign government-controlled transactions is a mandated 75-day examination period. This can be contrasted to all other covered transactions which are subject to a 30-day review and only move to the second stage investigation on a discretionary basis. In addition to the longer mandatory examination period, the fact of being a foreign government-controlled transaction is identified as a specific factor for consideration by the President when taking into account the requirements of national security.

If entities like CPPIB are subjected to this framework, they are placed at a significant disadvantage relative to other bidders in a competitive auction for a covered transaction. Depending on the circumstances, the prospect of enhanced scrutiny (in particular, the mandatory second stage investigation) could significantly reduce the interest of a seller in a bid by CPPIB or the interest of a bidding syndicate in having CPPIB join as a participant -- it may be the difference between CPPIB succeeding in a particular investment or not. The potential chilling effect on foreign investment of this competitive disadvantage may well be an appropriate price for the United States to pay in the interests of national security for foreign government-controlled investors but not for entities like the CPPIB that meet the following criteria:

- The entity is constrained by an investment-only, fiduciary mandate;
- No foreign government has access to the entity's assets to fund general government purposes or can influence investment decisions; and

- The entity maintains a high degree of transparency.

The forthcoming regulations to implement FINSA will provide a good opportunity to deal with the issue in a transparent way and provide clear guidance to the market, as well as an opportunity to encourage desired market behavior.

**Critical Infrastructure**

CPPIB also urges that "critical infrastructure" be clearly and narrowly defined, so that the purpose of FINSA is achieved without adding a burden to transactions that do not affect US national security. Consideration should be given to excluding from this definition:

- Physical infrastructure systems and assets for which there are viable alternatives. Examples would include power plants representing only a portion of a region's generating capacity; and roads, highways, almost all bridges, railways and airports (with respect to which there will always be alternative routes).

- Infrastructure systems and assets in sectors or industries where there are a number of competitors offering comparable services or products. Examples would include almost all financial institutions, transportation companies, and large parts of the energy sector.

- Health systems where there are viable public and private alternatives.

While some determinations must of necessity be fact specific, it is important that investors have as much guidance as possible on the meaning of "critical infrastructure" so that (i) foreign persons know when their transactions involve critical infrastructure and notice should be filed with CFIUS, and (ii) CFIUS is not inundated with cautionary filings for the many transactions that could fall under the broad definition but that do not raise any national security concerns.

## XI. Selected Third Party Commentary

- **OECD report entitled, "On Sovereign And Public Pension Reserve Funds: Sovereign Wealth & Pension Reserve Fund Issues (Room Document 1 (English)", December 4, 2007[2].**

  "While most of these funds, like the social security system itself, fall under the government sector, there are some exceptions. For example, the Canada Pension Plan (CPP) reserve fund is legally independent of government. The CPP has no financial guarantee from government and relies solely on mandatory pension

[2] See Directorate for Financial and Enterprise Affairs, Insurance and Private Pensions Committee, Working Party on Private Pensions, *OECD Seminar on Sovereign and Public Pension Reserve Funds – Sovereign Wealth & Pension Reserve Fund Issues*, copy of draft (subject to further revision) attached, at paras. 5.2(i) and 40.

contributions and investment income from the reserve fund to finance pension benefits for Canadian citizens. In this sense, the CPP reserve fund may not be considered a SWF.

- Some public pension reserve funds, like the Canada Pension Plan reserve fund, are even operated by private sector management entities (the CPP Investment Board) and led by a board of professionals independent of government. The board approves investment policies and makes critical operational decisions, such as the hiring of the president and chief executive officer and the setting of executive compensation. Such governance structures ensure a high degree of protection against political interference in the management of the reserve fund."

- **"Upgrading the Investment Policy Framework of Public Pension Funds", Dimitri Vittas, Gregorio Impavido, Ronan O'Connor. The World Bank. Financial Systems Department. Financial Policy Division. January 2008.**

  "The CPPIB operates with a strong governance structure. This is based on two important principles: independence from government and other interests, especially in making investment decisions; and full public accountability."

- **"Reforming The Canadian Retirement System: Investing Social Security Assets In Equities," By Steven A. Sass. Center for Retirement Research at Boston College. Global Issue in Brief April 2006, Number 5.**

  "The goal was to set a contribution and benefit that would be the same for each generation, using equities to minimize the cost of the program. The primary concern over the use of equities is political — will this mixture of politics and economics result in a loss of investment returns or, more troubling, in a loss of democratic control of politicians and government officials? To alleviate such concerns, Canada set up an elaborate governance system designed to make the CPP Investment Board professional and independent. Thus far, the CPP governance system is generally viewed as achieving these objectives."

- **The Washington Post, David Cho, *"A Growing Foreign Stake in U.S. Banks,"* January 16, 2008, available at:** www.washingtonpost.com/wp-dyn/content/article/2008/01/15/AR2008011503664_pf.html

  "Barney Frank (D-Mass.), who chairs the House Financial Services Committee, said that while there is potential for political 'games to be played' by sovereign wealth funds, the greater concern is the economic weakness that has eroded the power of the U.S. banking system.

  'The shift in power does not come from Singapore or Abu Dhabi investing in Wall

Street, the shift comes from our economy screwing up,' Frank said. 'And the way we deal with this is not to say we aren't going to accept foreign investments but to fix what's wrong with our economy.'" January, 2008 Washington Post article.

- **As Robert M. Kimmitt, Deputy Secretary of the U.S. Department of the Treasury, wrote in Foreign Affairs (January/February, 2008),**

  "To frame this policy discussion, it is useful to differentiate among four kinds of sovereign investment: international reserves, public pension funds, state-owned enterprises, and SWFs."

- Opening Remarks of Senator Charles Schumer, Chairman of the Joint Economic Committee (February 13, 2008),

  "It is clear we need to find out more about sovereign wealth funds – how they are run, what drives their investment decisions. Sovereign wealth funds should voluntarily provide information and agree to guidelines that promote good governance, accountability, and transparency. Here are some questions they should answer:

  - Do sovereign wealth fund officials report to an independent board of directors or directly to the government?
  - Do they disclose their investment goals? If those goals change, is that made public?
  - Are directors and the investment management team selected on the basis of business qualifications and not political affiliation? Are their professional qualifications and experience made public?
  - Is there a stringent code of conduct that compels members of the board of directors and management to report any attempts by the government to influence investment decisions?
  - Do they publicly disclose quarterly and annual audited financial statements?
  - Do they publicly disclose all their portfolio holdings?"

- Former Treasury Secretary Larry Summers, Harvard Charles W. Eliot University Professor, article in The Financial Times, *"Funds that shake capitalist logic,"* July 29, 2007, available at: www.ft.com/cms/s/2/bb8f50b8-3dcc-11dc-8f6a-0000779fd2ac.html: "The logic of the capitalist system depends on shareholders causing companies to act so as to maximize the value of their shares. It is far from obvious that this will over time be the only motivation of governments as

shareholders."

- Current SEC Chairman Cox Keynote Address and Robert R. Glauber Lecture at the John F. Kennedy School of Government, *'The Role of Government in Markets,* October 24, 2007, available at: www.sec.gov/news/speech/2007/spch102407cc.htm: "When individuals with government power also possess enormous commercial power and exercise control over large amounts of investable assets, the risk of misuse of those assets, and of their conversion for personal gain, rises markedly. Unchecked, this would be the ultimate insider trading tool."

- The Economist, *"Asset-backed insecurity,"* January 17, 2008, available at: www.economist.com/finance/displaystory.cfm?story_id=10533428: "...although the risk that the funds may abuse companies and markets is theoretical, the danger of financial protectionism is all too real. The idea that secretive foreign governments are up to no good exerts a powerful hold on the collective imagination."

On May 31, 2006, Standard & Poor's Rating Services report "Global Graying", compared 32 developed economies and concluded that the exceptional AAA rating on Canada would remain until 2040, after which it would only slightly decline to AA by 2050. All other countries in the sample except Denmark (AA) and Austria (A) would drop below investment grade by 2040. According to Standard & Poor's "Global Graying Country Report: Canada. June 6, 2006:

*"Canada's significant out-performance primarily reflects its strong initial fiscal position ... as well as the substantial reforms undertaken in the late 1990s to bring the finances of the Canada Pension Plan onto a sustainable footing. The benefits of the considerable efforts required to achieve both these timely reforms will be compounded in the coming decades."*

available at
http://www.ratingsdirect.com/Apps/RD/controller/Article?id=512877&type=&outputType=print&from=

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**INSURANCE AND PRIVATE PENSIONS COMMITTEE**
**WORKING PARTY ON PRIVATE PENSIONS**

**Room Document 1**
**(English)**

**OECD SEMINAR ON SOVEREIGN AND PUBLIC PENSION RESERVE FUNDS**

# SOVEREIGN WEALTH & PENSION RESERVE FUND ISSUES

**[Draft report made public during a seminar on December 4, 2007 in Paris. Subject to finalization.]**

# SOVEREIGN WEALTH & PENSION RESERVE FUND ISSUES

*Adrian Blundell-Wignall, Yu-Wei Hu and Juan Yermo**

## I. Introduction

1. Sovereign Wealth Funds (SWFs) are pools of assets owned and managed directly or indirectly by governments to achieve national objectives. They may be funded by: *(i)* foreign exchange reserves; *(ii)* the sale of scarce resources such as oil; or *(iii)* from general tax and other revenue. There are a number of potential objectives of SWFs, which are not always easy to attribute to a particular fund; and some funds may have more than one of the distinguishable objectives. Some of these are: *(i)* to diversify assets; *(ii)* to get a better return on reserves; *(iii)* to provide for pensions in the future; *(iv)* to provide for future generations when natural resources run out; *(v)* price stabilisation schemes; *(vi)* to promote industrialisation; and *(vii)* to promote strategic and political objectives.

2. These funds have raised concerns about: *(i)* financial stability, *(ii)* corporate governance and *(iii)* political interference and protectionism.

3. At the same time governments have formed other large pools of capital, in particular to finance public pensions, which are generally referred to as Sovereign and Public Pension Reserve Funds (SPPRFs). There are two such types of funds: those set up and owned directly by government (Sovereign Pension Reserve Funds, or SPRFs) and those belonging to the social security system (Public Pension Reserve Funds, or PPRFs). SPRFs may be considered a type of SWF with a specific mandate to finance future public pension expenditures. On the other hand, not all PPRFs may be considered SWFs. Some are legally independent of government and their balances are not integrated for national accounting purposes into the government accounts.

4. This paper focuses primarily on the issues at the broad macro level. It also compares the possible effects of different kinds of pools of capital, depending on how they are formed and on their governance, rules and strategies.[1]

## II. Definition and examples of Sovereign Wealth and Pension Reserve Funds

5. There is no single, widely accepted definition of a SWF. Two broad different types can be distinguished.

1. The first, a SWF, is a fund set up to diversify and improve the return on foreign exchange reserves or commodity (typically oil) revenue, and sometimes to shield the domestic economy from (cycle inducing) fluctuations in commodity prices. As such most invest in foreign assets. This group (in order of size) includes the Abu Dhabi Investment Authority (ADIA), the Government of Singapore Investment Corporation (GIC), the Saudi Arabian Monetary Authority (SAMA), the China Investment Corporation (CIC), Temasek Holdings

* Adrian Blundell-Wignall is Deputy Director in the OECD Directorate for Financial and Enterprise Affairs, and Yu-Wei Hu and Juan Yermo are consultant and principal administrator, respectively, in the Financial Affairs Division in the same directorate. The opinions expressed and arguments employed herein are those of the authors and do not necessarily reflect the official views of the Organisation or of the governments of its member countries.

(Singapore), The Central Huijin Investment Company (China), the Kuwait Investment Corporation (KIC), the Stabilisation Fund of the Russian Federation, The Reserve Fund of Libya, the Qatar Investment Authority (QIA), and many more. Where national resource funds are earmarked for particular regions, such as Canada's Alberta Heritage Savings Trust Fund, and the USA Alaska Permanent Fund, they are included as a SWF. Some of the above funds are set up to meet industrial objectives, such as regional development, as in Temasek, and the Central Huijin Investment Company.

2. The second broad type includes Sovereign and Public Pension Reserve Funds (SPPRFs). These could be defined as funds set up by governments or social security institutions with the objective of contributing to financing the relevant pay-as-you-go pension plans. Based on this yardstick, two sub-categories of pension reserve funds can be identified:

   (i) The first, Public Pension Reserve Funds (PPRFs), are set up as part of the overall social security system, where the inflows are mainly surpluses of employee and/or employer contributions over current payouts, as well as, in some cases, top-up contributions from the government via fiscal transfers and other sources. Among others, Denmark's Social Security Fund, Japan's Government Pension Investment Fund, and USA's Social Security Trust Fund fall within this category. These funds may be managed by the social security institution itself or an independent – often public sector – fund management entity. While most of these funds, like the social security system itself, fall under the government sector, there are some exceptions. For example, the Canada Pension Plan (CPP) reserve fund is legally independent of government. The CPP has no financial guarantee from government and relies solely on mandatory pension contributions and investment income from the reserve fund to finance pension benefits for Canadian citizens. In this sense, the CPP reserve fund may not be considered a SWF.

   (ii) The second type, Sovereign Pension Reserve Funds (SPRFs), refers to those funds which are established directly by the government (completely separated from the social security system), and its financial inflows are mainly from direct fiscal transfers from the government. Unlike the first type of reserve fund, those within this category have been set up by governments to meet future deficits of the social security system. Some are not allowed to make any payouts for decades. Examples include the Australian Future Fund, the New Zealand Superannuation Fund, the Irish National Pension Reserve Fund, the Norwegian Government Pension Fund, and the French *Fonds de réserve pour les retraites*. Some of these funds are sometimes treated as SWFs and indeed a few fit both definitions. For example, Norway's Government Pension Fund, established in 2006, is the result of the amalgamation of a pension reserve fund (the National Insurance Scheme Fund) and a SWF (the Government Petroleum Fund). It has a mandate beyond financing pension expenditures and is largely invested in foreign assets.

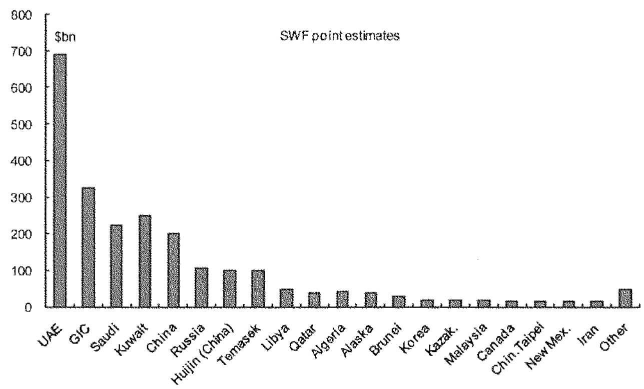
## III. How large are global SWF & SPPRF markets?

### *SWFs*

6. Some funds are a mix of SWF and pension assets which belong to individuals, as in the GIC, which manages these and foreign exchange reserves for the Monetary Authority of Singapore (MAS). Korea's investment authority has a similar mix of assets to manage. For this reason we include both as SWFs rather than SPPRFs. Norway's Government Pension Fund, on the other hand, while deriving its

funds from oil revenue, has since 2006 a specific mandate to finance future public pension expenditure and hence should be classified as a SPPRF.

**Figure 1. Sovereign wealth funds by size**




*Source:* Private sector market sources, central banks' balance sheets.

7. The size of the main SWFs are shown in Figure 1 and Table 1. At present, ADIA is the largest, at 29% of the total, followed by Singapore's 2 funds at 18%, China's 2 funds at 13%, the Saudi Arabian Monetary Authority (not foreign exchange reserves) at 10%, and the Kuwait Investment Authority at 7%.

8. Our estimate of total SWF pools is around USD 2.4 trillion, but they are getting bigger at a rate that is beginning to alarm some commentators. SWFs are likely to grow rapidly with the current configuration of foreign exchange policies, the relative weakness of the US dollar and the current oil price. For example, Chinese intervention policies are generating accelerating increases in reserves at present (a staggering USD 446 billion in the year to September 2007, versus USD 247 billion in the year to December 2006). China is beginning the process of transferring this money to SWFs and SPPRFs. So there is scope for rapid acceleration in these entities.

**Table 1. Sovereign wealth funds estimates**

Assets under management in USD billion, various dates

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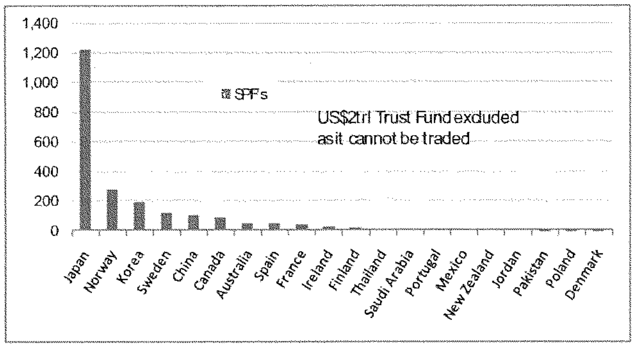
*Note:* This table reflects the OECD definition of a SWF – it excludes Sovereign Pension Funds, and excludes obvious overlaps (*e.g.* HK Monetary Authority using the GIC to invest).

*Source:* Peterson Institute, Deutsche Bank, OECD, national sources. Data for worldwide mutual funds is from Investment Company Institute. Total pension fund data is from OECD Global Pensions Statistics Project.

9. Transfers to oil producers are also accelerating. At a (say) USD 70 oil price and say 85 million barrels per day consumption, the world is handing over revenue of over USD 2 trillion per annum. There are costs of producing oil, and some of the surplus is consumed—but the sums are very large indeed.

10. The total amount for SPPRFs is an even larger USD 4.2 trillion as of 2006, if the US Trust Fund is included, some 49.6% of the total. This reduces to USD 2.2 trillion if we exclude the US Trust Fund, on the grounds that the amount cannot ever be traded because it is a notional accounting figure (IOU number) based on accumulated surpluses lent to the government. The USD 2.2 trillion is shown in Figure 2. USD 1.2 trillion was accumulated by Japan's National Reserve Funds – accounting for 29.5% of the total; USD 278 billion by Norway, some 6.7% of the total; and USD 191 billion by Korea, at about 4.6% of the total.

**Figure 2. Sovereign and public pension reserve funds assets by country, in USD billion**




*Source:* OECD and national sources.

11. Some of the SPPRFs, especially those of the sovereign (longer-run accumulation) kind, are relatively new. For example, Australia's Future Fund was established in 2006, New Zealand's Superannuation Fund was established in 2001 and China's National Social Security Fund in 2001. Given their short history, their assets are smaller than those in the more mature funds. However, some of these funds are growing rapidly. For example, as of 2006, the Future Fund in Australia had assets equivalent to USD 13.6 billion, while this figure increased to USD 45 billion as of August 2007.

12. In terms of total assets relative to the respective national economies (*i.e.* GDP), Table 2 shows that Norway has the biggest system, *i.e.* 83% in 2006. The other countries where pension reserve funds were significant relative to the economy include Sweden (30.6%), Japan (27.9%) and Korea (21.5%). On average, the ratio of OECD SPPRFs assets to GDP was 15.4% in 2006.

13. Table 2 also gives information on the governance of pension reserve funds, and specifically whether the fund is independent of the government, where independence is defined as having a board without government employees. For example, for the Australian Future Fund and the Irish National Pensions Reserve Fund, operation is fully independent of government. In most countries, however, the boards of reserve funds have some government employees in their boards.

**Table 2. Statistical summary of Sovereign and Public Pension Reserve Funds by region and type, 2006**

| | Country | Name of the fund/institution | $ bn 2006 | % of total 2006 | % of GDP 2006 | Ind.of govt. |
|---|---|---|---|---|---|---|
| **OECD: PPRF** | Canada | Canadian Pension Plan | 86.39 | 2.09 | 6.80 | Yes |
| | Denmark | Social Security Fund | 0.66 | 0.02 | 0.24 | No |
| | Finland | The State Pension Fund | 12.93 | 0.31 | 6.17 | No |
| | Japan | National Reserve Funds | 1,217.55 | 29.49 | 27.88 | No |
| | Mexico | IMSS Reserve | 7.39 | 0.18 | 0.88 | No |
| | Spain | Fondo de reserva de la seguridad social | 44.87 | 1.09 | 3.66 | No |
| | USA | Social Security Trust Fund | 2,048.11 | 49.60 | 15.53 | No |
| **OECD: SPRF** | Australia | Future Fund | 45.00 | 1.09 | 5.70 | Yes |
| | France | fond de reserve des retraites' (FRR) | 39.14 | 0.95 | 1.74 | No |
| | Ireland | National Pensions Reserve Fund | 23.71 | 0.57 | 10.75 | Yes |
| | Korea | National Pension Fund | 190.84 | 4.62 | 21.49 | No |
| | New Zealand | New Zealand Superannuation Fund | 6.67 | 0.16 | 6.32 | Yes |
| | Norway | Government Pension Fund: Global | 278.12 | 6.74 | 83.04 | No |
| | Poland | Demographic Reserve Fund (DRF) | 1.76 | 0.04 | 0.60 | No |
| | Portugal | Social Security Financial Stabilization Fund | 8.33 | 0.20 | 4.28 | No |
| | Sweden | National Pension Funds (AP1-AP4 and AP6) | 117.47 | 2.84 | 30.61 | No |
| | **OECD:Total** | | **4,128.95** | **100.00** | **15.40** | |
| **Non-OECD: PPRF** | China | Pillars 1A and 1B | 35.48 | 27.31 | 2.62 | No |
| | Jordan | Social Security Corporation | 6.02 | 4.64 | 46.20 | No |
| | Pakistan | Employees' Old-Age Benefits | 1.82 | 1.40 | 1.47 | No |
| | Saudi Arabia | General Organisation for Social Insurance | 8.62 | 6.64 | 2.41 | No |
| | Thailand | Social Security Office | 9.07 | 6.99 | 5.10 | No |
| **Non-OECD: SPRF** | China | National Social Security Fund | 68.87 | 53.02 | 1.35 | No |
| | **Non-OECD:Total** | | **129.9** | **100.00** | **3.9** | |

*Note:* Australia is August 2007. Ind. Of govt.: independent of government. PPRF stands for Public Pension Reserve Fund. SPRF stands for Sovereign Pension Reserve Fund. For definitions see main text.

Source: OECD.

### IV. SWFs and SPPRFs: similarities and differences

14. SWFs and SPPRFs share some similarities. Both are very large in terms of assets under management, and are autonomous and accountable only to governments or public sector institutions. Like SWFs, SPPRFs are also increasingly investing abroad and moving into alternative assets (property, private equity and hedge funds). Hence the financial stability concerns raised over SWFs are also applicable to SPPRFs.

15. However, there are still a number of discernable differences between SWFs and SPPRFs.

1. The objectives of these funds are different. SPPRFs serve as a long-term financing vehicle of public pensions and other related benefits, while SWFs are normally established to shield the domestic economy from fluctuations in commodity prices (*e.g.* oil) and to diversify foreign reserve holdings into higher return assets, among others. Hence, the investment horizon of SPPRFs tends to be longer than that of SWFs. Some SPPRFs even have specific timeframes for drawing down funds and at least one (the Canadian one) aims to meet a funding target (the ratio of public pension asset to liabilities). Clear objectives and investment timeframes shed much clarity to the mission of SPPRFs and are conducive to better governance and more efficient investment management.

2. In many countries SPPRFs face strong pressures to invest their resources domestically and conservatively. This is more the case of SPPRFs managed within the social security system. Three of the four largest SPPRFs, the US Social Security Trust Fund, the Japanese GPIF, and the Korean National Pension Fund are largely (solely in the US case) invested in domestic government securities. In emerging markets, where institutional investors and capital markets are

underdeveloped, it is sometimes felt that SPPRFs should help promote domestic investment and financial sector development. These concerns contrast with those of SWFs which are by construction mainly invested only in foreign assets.

3. As noted earlier, SWFs and SPPRFs have different sources of funding. SWFs are mainly financed by foreign exchange revenues on commodity exports and/or transfers of foreign reserves from the Central Bank. SPPRFs, on the other hand, are more often financed via social security contributions or direct fiscal transfers from the government.

16. SPPRFs may also raise issues concerning fiduciaries' responsibilities and of social ownership by pensioners of SPPRF assets. Trustees may constrain what these funds can do and require greater transparency than is the case for SWFs. For example, most SPPRFs have policies for socially responsible investments.

### V. SWF and SPPRFs' asset allocation across countries

17. Consistent with this latter observation (point 4 above), we found it much easier to extract information about SPPRF governance and asset allocations than we did for SWFs. It is extremely difficult to find information on actual SWF sizes and investment allocations. One concern about SWFs is that their governance, investment objectives and asset allocations may reflect strategic objectives.

**Table 3. Asset allocation information SPPRF's in 2006**

| | | EQUITIES | BONDS | CASH | PROPERTY | ALTERNATIVE INV. |
|---|---|---|---|---|---|---|
| OECD | Australia | | | | | |
| | Canada | 58.5 | 31.8 | 0.6 | 4.6 | 4.5 |
| | Denmark | 0.7 | 26.4 | 67.0 | | |
| | Finland | 40.4 | 55.5 | | 1.3 | 0.9 |
| | France | 62.1 | 26.4 | 11.5 | | |
| | Ireland | 77.1 | 13.3 | 4.7 | 3.0 | 0.6 |
| | Japan | 37.3 | 62.7 | 0.0 | | |
| | Korea | 8.9 | 89.3 | 0.4 | | 1.2 |
| | Mexico | | | | | |
| | New Zealand | 60.0 | 20.1 | | 7.2 | 12.7 |
| | Norway | 40.7 | 59.3 | | | |
| | Poland | | | | | |
| | Portugal | 20.8 | 70.1 | 2.2 | 3.6 | |
| | Spain | 0.0 | 100.0 | | | |
| | Sweden | 59.5 | 36.7 | 0.8 | | |
| | USA | 0.0 | 100.0 | | | |
| Non-OECD | China | 24.2 | 53.7 | 9.5 | | |
| | Jordan | | | | | |
| | Pakistan | | | | | |
| | Saudi Arabia | | | | | |
| | Thailand | | | | | |

*Note:* "Alternative investments" refer to "private equity" for Canada, Finland and Ireland, while that for Korea and New Zealand refers to various alternative asset classes.

*Source:* National sources and OECD.

18. Information on objectives and asset allocations is more readily available for SPPRFs, though there are differences between funds in this respect. For most of the countries for which data are available, bonds and equities are the largest components in SPPRFs' portfolios (see Table 3). For example, as of 2006 France's FRR allocated 62.1% of its total assets to equities and 26.4% to bonds, while the remaining 11.5% was invested in other assets. At the extreme, SPPRFs in Spain and the USA, invested all assets in

short-term assets and bonds. For the US Trust Fund, such conservative investment strategy is mandated in the relevant legislation.

19. Over time, there is a trend of increased allocation to equities and declining bond allocations in some countries. For example, equities accounted for 15.6% of the Canadian Pension Plan assets, while bonds accounted for 63.0% in 2001. In 2006, these two figures were 58.5% and 31.8%, respectively. A similar trend was observed in France, Finland, and Portugal.

20. Generally speaking, because of its low returns, cash and its equivalent do not account for a significant share of the SPPRF portfolios, except for Denmark.

21. In contrast, recently there has been an increased exposure to high-yield, alternative assets, *e.g.*.private equity. This trend is driven by the perceived low correlation between alternative and traditional asset classes and pressure on SPPRFs to beat market benchmarks (so-called "beta") and seek higher "alpha" via active management. In most cases, active management is delegated to professional fund managers, though a few SPPRF's (e.g. Canada's) carry out such investments in-house. Alternative investments accounted for 1.2% of the Korean National Pension Service funds as of 2006, while this figure was 0.9% for Finland. A major increase in the alternative asset allocation was implemented by the New Zealand Superannuation Fund (12.7% in 2006, from 0.5% a year earlier). China made an investment in Blackstone in 2007.

22. Some SPPRFs are also increasing their allocation to foreign assets, though this information is not readily available for some funds. For the countries where statistics are available, the trend has been towards rapid increases in overseas investment. Examples include the 35.4% overseas investment of Irish SPPRFs[2], and 75.9% overseas investment of New Zealand's Superannuation Fund in 2006. France's FRR started to invest in foreign assets (defined as assets denominated in non-Euro currencies) in 2004, with 5.1% of total assets, and this increased to 29% by 2006. Foreign assets accounted for only 0.3% of Korea's NPS in 2002, but this increased to 9.6% in 2006. In Japan, foreign assets accounted for a large share and were on a steady rise, from 19.4% of the total portfolio in 2001 to 25.5% in 2006. Norway's Government Pension Fund-Global is fully invested in foreign assets, a large part of it (61%) in currencies other than euro.

**VI. Global financial stability issues**

23. Financial stability issues often come from two broad sources:

1. Excessive liquidity creation reflected in asset price inflation, and the encouragement of low interest rates and leverage.

2. Excessive concentrations of investments in particular securities.

***(1) Liquidity***

24. The creation of excessive global liquidity can cause asset bubbles. Fixed exchange rates in the face of capital inflows lead to foreign exchange accumulation and, if impossible to fully sterilize, easier domestic monetary conditions. This can contribute to local asset bubbles. The global investment of the reserves may affect prices in other financial markets.

25. The staggering growth of global reserves since the late 1990's is shown in Figure 3. Similar episodes have occurred during weak dollar periods in the past when Japan was the main driver. China has been a more consistent accumulator since the mid 1990s devaluation, and currently has USD 1.3 trillion of the (above) USD 5 trillion total. In periods of USD weakness Japan has carried out massive interventions,

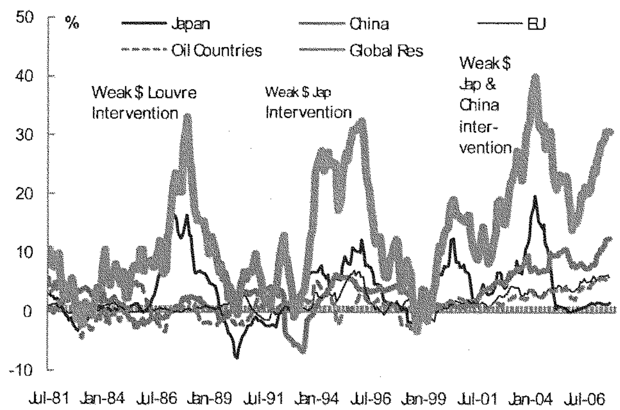
as can be seen from the chart. While Japan has huge holdings of foreign reserves, it has now been eclipsed by China as the major holder.

26. Rapid reserve accumulation has contributed to asset price pressures.

27. Foreign exchange intervention by central banks is typically carried out in US dollars and invested in US Treasury securities. This has served to keep US bond yields abnormally low relative to short rates, hence influencing other rates (e.g. mortgages at the fixed rate end) and the cost of capital more generally. This, in turn, influences leverage and asset prices through that channel.

**Figure 3. Global USD reserves and contributions**

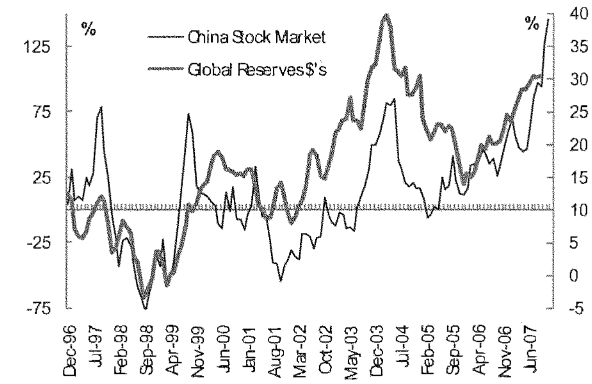
Chinese intervention now dominates




*Source:* Thomson Financial Datastream and OECD.

28. The growth of global reserves and China's stock market are shown in Figure 4. The mechanism here is that when risk taking rises, investors buy into emerging markets creating capital inflow into countries like China that fix or quasi fix their exchange rate. This eases monetary policy and contributes to stock market booms.

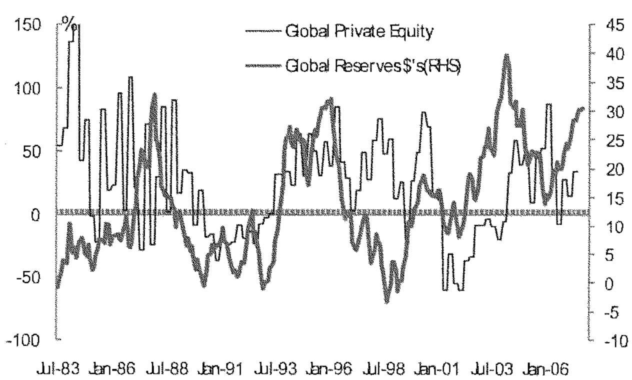
**Figure 4. Global Reserves and China's Stock Market**




Source: IBES, Thomson Financial Datastream.

29. The growth rates of global reserves and of private equity deals are shown in Figure 5. Private equity has been in a bubble until recently.

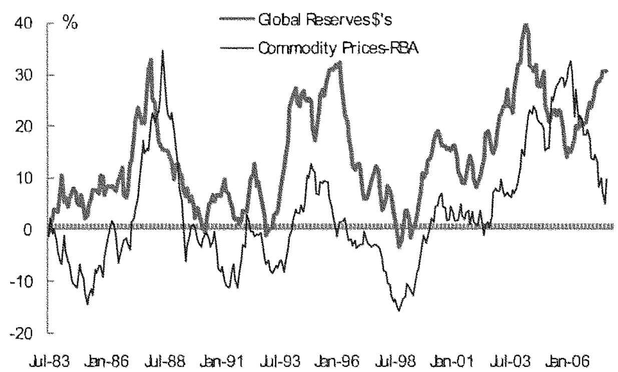
**Figure 5. Global liquidity and private equity deals**




*Source:* Thomson Financial Datastream.

30. The global reserves and a commodity price index constructed by the Reserve bank of Australia (with a heavy weighting to materials used by China – energy, base metals, bulks) is shown in Figure 6. This is one of the bubbles that commodity funds have invested in. The hedge fund Amaranth had difficulties with respect to this bubble.

Figure 6. Global liquidity and commodity prices




*Source:* Thomson Financial Datastream.

31. While foreign exchange reserve accumulation can create liquidity, this is not the case for SWF's. If a part of the USD foreign exchange reserves is transferred to a SWF, the central bank gets a credit and the SWF invests the reserves. There are indirect and second round effects, but no primary liquidity is created. If the SWF switches out of dollars into another currency, there will be an exchange rate impact (one reason why China can't really do this). If it switches out of one asset like a Treasury security to another one like an equity stock, there will be an asset price impact. Given the large size of some SWFs, changes in the strategic asset allocation, such as a shift from bonds to equities, could have a significant impact on the relative prices of these two asset classes. The price impact will also vary depending on whether the changes in portfolio allocation are carried out via new fund inflows (as is the case during periods of rapid asset accumulation, like the one we are going through) rather than the sale of existing assets. Stronger price effects can be expected once the growth rate of the funds slows down and changes in the investment policy can no longer be implemented solely by shifting inflows.

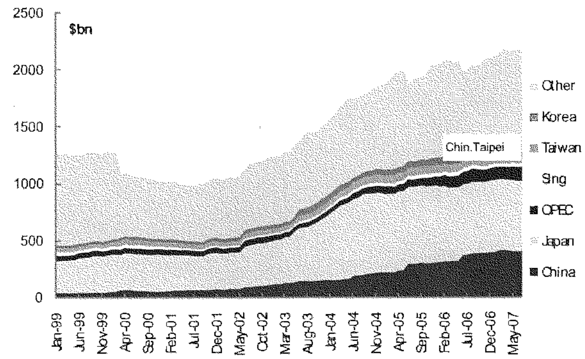
32. If a SWF provides capital to a private equity company, like Blackstone, the latter may lever this amount at the low global cost of capital (where the carry trade and other forces are at play). If they invest in smaller emerging markets which are less liquid they might increase volatility. But there are much bigger pools of capital in the West which will have exactly the same effects.

***(2) Excess Concentration***

33. SWFs provide mechanisms for breaking up concentrations of portfolios that increase risk.

34. USD 1.4 trillion of Chinese reserves invested mainly in the US Treasury market distorts the yield curve in the US, and sudden changes could lead to USD and yield effects that could hurt (certainly) China and possibly the USA. By shifting assets to SWFs, the foreign exchange reserve concentration is reduced.

**Figure 7. Foreign holdings of US Treasury securities**




*Source:* Thomson Financial Datastream.

35. The official holdings of US Treasury Securities by some foreign governments are shown in Figure 7. The rising trend has been driven by Japanese and Chinese foreign exchange intervention policies. In this context it is also very clear that Singapore and OPEC, both of which are associated with the largest SWFs, and by some considerable margin, have very little holdings of US Treasury Securities. In other words, SWFs invest in a much more diversified way and do not concentrate their holdings in US Treasury Securities.

36. Many SWFs also hire external managers as a part of normal style diversification. Investing in equities in Western countries requires 'buying' experienced in-house teams, or outsourcing to western funds management firms, private equity companies and hedge funds. Once again, these structures and strategies are diversifying.

***(3) Governance***

37. To the extent that commercial considerations allow, clear corporate governance and full accountability are important for all public funds. Similar issues apply to both SWFs and SPPRFs. SPPRFs appear to have better transparency in these areas, and this probably follows from the clearer mandate and the fiduciary and pensioner ownership considerations that have become a part of the generally accepted wisdom in the pension area. Where these lines should be drawn for SWFs is less clear.

38. The clearer mandate of SPPRFs stems from their founding purpose, which is to meet pension benefits. As a result, some SPPRFs have specific investment return targets and concomitant investment strategies that have been designed on purely financial grounds. In particular, SPPRFs try to achieve a rate of return that will help maintain the actuarial balance of the public pension system. In contrast, most SWFs have diffuse investment objectives, which can expose them to manipulation for political purposes.

39. Another difference with most SWFs, is that many SPPRFs, at least those of the sovereign type, are governed by boards that have been selected according to strict criteria of knowledge and professional experience in financial matters. The governing body of an SPPRF of the sovereign type is typically either an independent committee (like the National Pensions Reserve Fund Commission in Ireland) or the highest

organ of an independent legal entity that is exclusively responsible for the management of the reserve fund (like the Board of the Guardians of New Zealand Superannuation). One of the strictest eligibility requirements for board members is in place in New Zealand, where all board members must have experience and expertise in investment management, and at least four must be qualified as investment professionals.

40. Some public pension reserve funds, like the Canada Pension Plan reserve fund, are even operated by private sector management entities (the CPP Investment Board) and led by a board of professionals independent of government. The board approves investment policies and makes critical operational decisions, such as the hiring of the president and chief executive officer and the setting of executive compensation. Such governance structures ensure a high degree of protection against political interference in the management of the reserve fund.

41. While operating at arm's length from government, many SPPRFs are subject to rigorous accountability requirements. Accountability is primarily exercised via strict disclosure requirement and oversight by relevant authority. SPPRFs are required to publish an annual report, to have their accounts audited by an independent external audit firm (or in some cases the public audit office) and to provide regular and timely information on their website.

42. Disclosure is a particularly sensitive topic for both SWFs and SPPRFs. Commercial considerations argue against detailed disclosure of investments in both SWFs and SPPRFs. At the same time, there is a need to promote the transparency of the funds' investment policy. Public disclosure of asset allocation and investment performance at sufficiently long intervals (e.g. one year) and with prudent delays (a few months) can help meet the goal of transparency without jeopardising the fund's confidentiality over some aspects its investment management.

43. In conclusion, lessons can be learnt from existing SPPRFs in OECD countries for the debate on the design, operation and role of SWFs in the global financial system.

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[1] A version of this paper served as background for discussion at the October 2007 meeting of the OECD Committee on Financial Markets. Other aspects related to SWFs have been addressed in other OECD Committees, in particular the Steering Group on Corporate Governance, the Working Group on Privatisation and Corporate Governance of State-Owned Assets, and the Investment Committee.

[2] Note that For SPPRFs in France, Ireland, Norway and Sweden, foreign investments refer to those investments in assets outside the Euro zone or denominated at non-Euro currencies.

CPP
INVESTMENT
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**The Case for Clarity:**
**Sovereign Wealth Funds and the Canada Pension Plan Investment Board Governance Model**

**Notes for remarks by**
**Gail Cook-Bennett**
**Chair**
**Canada Pension Plan Investment Board**

**CHECK AGAINST DELIVERY**

**"Sovereign and Public Pension Reserve Funds"**
**An OECD Seminar**
**Working Party on Private Pensions**
**Directorate for Financial and Enterprise Affairs**
**Organization for Economic Cooperation and Development**
**Tuesday, December 4, 2007**
**Paris, France**

Good afternoon. I am very pleased to have been invited to participate in this important and highly topical discussion on Sovereign and Public Pension Reserve Funds. I commend this OECD committee for its efforts to encourage best practices in pension fund governance through working sessions such as these. One of the ideas I want to share with you today is that a national pension reform model created in Canada 10 years ago may provide some relevant concepts and potential solutions to some of the public policy challenges presented by Sovereign Wealth Funds today.

Sovereign Wealth Funds, as you well know, are not new – they have been around for decades. What *is* new is that these funds have emerged in recent years as active direct investors – acquiring sizable international assets in sensitive industries, such as transportation infrastructure, telecommunications and energy. Also, they are growing at an astounding pace. Deutsche Bank has estimated that Sovereign Wealth Funds today hold $3 trillion in assets – double the size of the global hedge fund industry – and could grow to $10 trillion in 10 years.

Consequently, and not surprisingly, the role of Sovereign Wealth Funds in global capital markets has escalated into an international public policy issue with extensive political and economic implications, and with concerns being expressed by governments, regulators and other opinion leaders.

We have heard plenty through the media about those concerns: that Sovereign Wealth Funds are controlled by governments, are opaque and that they may use their financial clout in the pursuit of non-commercial national security, political or economic objectives.

In response, we are already seeing calls for new protectionist legislation, which could have negative consequences for the free flow of capital and access to global investment opportunities. This would penalize not just Sovereign Wealth Funds but return-driven national pension funds operating with much higher transparency.

The threat to these return-driven investors is clear. They may be mislabeled as Sovereign Wealth Funds simply because they are national funds. We believe that policymakers and opinion leaders can facilitate clarity by looking beyond the labels of Sovereign Fund, Sovereign Pension Fund and so on, to examine the underlying characteristics of these large pools of capital. They can then be better positioned to consider public policy based on facts, not labels.

As the Chair of the Canada Pension Plan Investment Board I know that we have, on occasion, been incorrectly categorized as a Sovereign Wealth Fund. While we do have the word "Canada" in our name, the CPP Fund, managed by the Canada Pension Plan Investment Board, is neither a sovereign entity nor a sovereign fund. And we are <u>not</u> a sovereign fund for a number of reasons:

- Our assets are not government assets. Rather they are contributed directly by employees and employers.

- We do not receive any tax revenues or fiscal top-ups.
- Assets are strictly segregated from government assets.
- And by law, we operate at arm's length from government, with very high transparency and abide by a clear and singular mandate to "maximize investment returns without undue risk of loss."

Based on those characteristics, some observers would not even classify us as a public pension reserve fund.

But Canada's model for national pension reform can offer some lessons about managing a large and growing pool of capital – lessons that may be applicable to Sovereign Wealth Funds. These lessons centre on the twin concepts of clarity of purpose and transparency. Based on the Canadian experience, we believe that if observers had the answers to five key questions about the objectives of Sovereign Wealth Funds, the public policy debate would be better informed and would result in a more judicious response to the issue. Those questions would be:

- Number 1: For what purpose was the Sovereign Wealth Fund or Sovereign Fund created?
- Number 2: How will the funds be used?
- Number 3: What is the governance and oversight structure?
- Number 4: How is the investment policy created?
- Number 5: Is there sufficient disclosure on all of the above?

At the CPP Investment Board, we were fortunate to have all of these questions answered for us – albeit for an entirely different reason – when we were created as part of the Canada national pension reform model in 1997 – 10 years before the current concern about Sovereign Wealth Funds.

**Why Was the Fund Created?**

In answer to Question 1, Why was our fund created?, Canadian policymakers answered – to help sustain the Canada Pension Plan. In 1996 the Canada Pension Plan, like many public pension plans, was facing a pension funding crisis. That year, it received C$11 billion in contributions and paid out C$17 billion in benefits, with an asset base of more than C$35 billion. Unless something was done, the plan's collapse would be only a matter of time. Today the CPP Fund has more than C$120 billion in assets (roughly €82 billion), earned a 13.6 per cent annualized investment rate of return over the past four fiscal years and has grown by about C$80 billion since inception – two-thirds of which derived from investment income. Canada's Chief Actuary has estimated in his latest report that the fund will grow to more than C$310 billion by 2019 and has projected that the CPP will be sustainable throughout the 75-year period of the report.

The model Canada created to solve its national pension crisis set the CPP on a solid financial footing. At the same time, it has been cited as a best-practice model for pension fund governance around the world because of its mutually reinforcing set of governance characteristics that include clarity of purpose and transparency.

We recognize that Canada's model was created in response to a unique set of facts and circumstances. But based on the steady stream of visitors from other national pension funds who come to study our model, we believe that some elements of Canada's blueprint for national pension reform could help address not only the governance issues of other pension plans, but also some of the problems of Sovereign Wealth Funds today.

From our advance materials you will have noted that the Canada Pension Plan is a national defined benefit pension plan operated for the benefit of 17 million Canadians. And we, as the CPP Investment Board, were created as a purely return-driven professional investment management organization to operate in the private sector and to make investment decisions at arm's length from governments.

So why did Canada devise such a different national pension plan model – a model that we at the Canada Pension Plan Investment Board did not create. The design was the fruit of an extraordinary policy reform process involving Canada's federal government and nine Canadian provinces working together in the mid-1990s to rescue the Canada Pension Plan. From the outset, their top priority was to create a governance structure that would protect the organization – including its board, its management, its assets and its investment decisions – from political interference. The fact that these politicians identified political interference as our greatest threat is remarkable in itself. The solution they devised to achieve their goal was original, bold and visionary. And it has worked.

Let me bring it alive for you with three examples of day-to-day operational life at our organization.

- First: We do not submit our investment strategy or business plans for government approval.
- Second: We do not have government officials sitting on our board.
- Third: We do not submit our compensation policies and pay levels for government approval.

**How will the funds be used?**

The policymakers also saw the importance of clearly answering Question 2: How will the funds be used? Their answer: to help pay pensions and nothing else.

Powerful Investment Mandate

To reinforce absolute clarity about the CPP Investment Board's objective, the reforms called for a simple, but powerful investment-only mandate. To quote from our legislation, we are mandated to achieve, **"a maximum rate of return without undue risk of loss"**. The legislation goes further. It stipulates that we must not pursue other objectives that are inconsistent with that investment mandate.

So, for example, there is no pressure or obligation for the CPP Investment Board to invest in Canada, buy government debt, make loans to state-owned firms, provide credit to governments, invest in politicians' favourite projects or invest with a view to any

particular social policy agenda other than the goal of helping to secure Canada's national pension plan.

Segregating the Assets

Segregating the pension assets from government revenues was another vital part of the framework they built to ensure that the funds would be used as intended. After all, these assets are contributed directly by working Canadians – employees and employers – as part of a defined benefit pension plan and the money belongs to the millions of Canadians who are contributors to or beneficiaries of the plan. They are not government assets funneled to the plan through the tax revenue system. Indeed the Canadian government is neither a sponsor nor a guarantor of the plan.

**And what is the governance and oversight structure?**

With the investment mandate articulated and the funds segregated, the policymakers also recognized the importance of answering Question 3: What is the governance and oversight structure?

Governance Structure Based on an Arm's-length Relationship with Governments

The answer was clear: a governance structure based on an arm's-length relationship with governments. Although many organizations say that they are arm's length from governments, the CPP Investment Board's legislated structure and subsequent measures adopted by the board make this claim a reality. The reforms called for management to report not to governments, but to an independent and qualified board of directors. Board

members possess strong credentials in business, finance, actuarial science, portfolio management and other relevant disciplines. Moreover, directors are appointed through a nominating process that balances governments' legitimate role in selecting directors with private sector input to identify directors with the requisite expertise and independence. To be clear, these are not political appointments or representatives of a given constituency, but rather a group of qualified professionals with a common duty to serve the best interests of the Plan's contributors and beneficiaries.

An example of the board's commitment to the arm's-length principle is embedded in its Code of Conduct. In accordance with the Code, directors, officers and employees have a positive duty to report immediately any attempted political influence if they have been subjected to pressure with respect to investment, procurement or hiring decisions. In our nine years of operation, there has never been any attempted influence. So ours is a pure investment-only mandate that meets the standard of "commercial-only".

**How is the Investment Policy Created?**

Which brings us to Question 4 – How is the Investment Policy Created? The board of directors, not governments, approves investment policies, determines with management the organization's strategic direction and makes critical operational decisions such as hiring the Chief Executive Officer and determining executive compensation. The CEO, in turn, hires and leads the management team, including the investment professionals who make portfolio decisions within investment policies agreed to by the board of directors.

This organizational structure ensures that investment professionals make investment decisions at arm's length from governments.

**Is there Sufficient Disclosure?**

And finally Question 5: Is there sufficient disclosure?

Transparency and Accountability

Policymakers ensured that our legislation required a high level of transparency and our board and management have voluntarily raised transparency to an even higher level. Early in the life of the CPP Investment Board, the board of directors adopted a disclosure policy that states:

> *"Canadians have the right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf, and how the investments are performing."*

The power and effectiveness of this disclosure policy has served us well.

We report our results on the same basis as most Canadian public companies, including the presentation of independently audited financial statements, as well as the inclusion of a Management's Discussion and Analysis and a Compensation Discussion and Analysis, in our annual report.

In addition, we post our investment policy and objectives on our website as well as a full list of our public equity holdings. The website also identifies our private investment fund partners and real estate fund partners, how much we have committed to their funds, and how much has been drawn down. We believe that it is possible to provide a very high degree of transparency without compromising our proprietary investment insights.

In addition to these voluntary measures we have adopted, our legislation imposes a duty on us to hold public meetings every two years in all nine participating provinces, to participate in a federal/provincial triennial review of the Canada Pension Plan, and to open our books for a routine special examination every six years.

## Changes to the Model

### The Act

There is one powerful element of our governance model that I have left until the end because it is a product of our federal/provincial system. Any changes to our Act, which enshrines our governance model, would require agreement between the federal government and two-thirds of the provinces representing two-thirds of the population in order to amend the legislation. This is the same formula required for amending Canada's constitution – a high standard indeed in Canada. It prevents unilateral and potentially ill-considered or hasty changes. Changes are possible, but only after full consideration of the potential implications. The federal and provincial governments' commitment in enacting these reforms was truly extraordinary.

All told, it amounts to a far-sighted formula that was designed with intense collaboration in response to a funding crisis.

Finally let me reflect on two things. First, our model is uniquely well-suited for our purposes and each piece of the formula is vitally important in preserving the maximum-strength quality of our governance model. We believe that if one element of the model were removed it would significantly weaken our protections. Secondly, for other pools of capital around the world that are addressing problems unique to them, it may be appropriate to adopt elements of the Canadian blueprint to help solve those problems.

For those pools of capital, it will be increasingly important to articulate the specific measures that clarify and codify their investment objectives. Transparency, while not easy, is rewarding. It imposes extraordinary accountability, to be sure, but pays for itself with the trust and confidence it enables an organization to build with others.

So to conclude, I leave you with three messages.

The CPP Investment Board is not a Sovereign Wealth Fund and should not be caught up in the fear surrounding these entities. I have detailed the power of our governance model in support of this fact.

Some Sovereign Wealth Funds might be able to respond to fears about their motives by clarifying their objectives and generally increasing their transparency.

Increased transparency by these funds would contribute to a more informed debate and would allow international policymakers to move beyond labels and offer more judicious responses to this challenge.

Thank you.

**Foreign Government Investment in the United States Economy and Financial Sector**

***Temasek Holdings: A Dependable Investor in the United States***

**Testimony of Simon Claude Israel**

**Executive Director and Member of the Board**

**Temasek Holdings (Private) Limited**

**before the House Financial Services Committee --**

**Subcommittee on Domestic and International Monetary Policy, Trade and Technology;**

**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises**

**March 5, 2008**

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Mr. Chairmen, Ranking Members, Chairman Frank, Members of the Committee:

My name is Simon Israel and I serve as an Executive Director and Member of the Board of Temasek Holdings. I thank you for the opportunity to present our views in your deliberations.

**Overview**

Temasek Holdings is a Singapore-based investment holding company founded in 1974. Temasek has a professional management team comprising 40 percent non-Singaporeans at its senior levels, and is headquartered in Singapore, a trusted friend and partner of the United States.

Temasek is known in the global investment community as a responsible and disciplined long-term investor with a mandate to maximize sustainable shareholder value, with a strong reputation for high standards of integrity and corporate governance.

From an initial portfolio of S$350 million in 1974 made up of various Singapore start-ups, Temasek's investment exposure has grown over the last 30 years into a globally diversified portfolio of about US$110 billion, covering a range of industries, including financial services, transport and logistics, telecommunications and other infrastructure and engineering services. Singapore and Asia account for nearly 80 percent of Temasek's investments, while developed markets such as the United States and Europe are a long-standing and growing part of our portfolio.

**Temasek Investments in the United States**

Temasek has multifaceted investment ties to the United States, both directly and indirectly via its portfolio companies. Temasek's US$4.4 billion investment in Merrill Lynch last December is only the latest financial linkage we have with America. Other direct Temasek investments include start-up companies in Silicon Valley as well as investments in various private equity and hedge funds in the United States as well as investments in the public markets.

Several Temasek portfolio companies have significant U.S. operations. For example, Singapore Technologies Telemedia, a wholly owned subsidiary of Temasek, owns two thirds of Global Crossing (employing more than 2,000 people in the United States), and Keppel Corporation, which is active in network engineering and natural resource services, supplies competitively built oil rigs for American companies in the oil and gas industry. California-based American President Lines (APL) -- wholly owned by Neptune Orient Lines in which Temasek holds a two-thirds interest -- is a major container shipment firm. APL, which operates ports in three western states, is the Defense Department's second largest cargo carrier and employs more than 3,100 people in the United States. Virginia-headquartered VT Systems -- a wholly-owned subsidiary of Singapore Technologies Engineering -- is a leading supplier to the U.S. armed forces of sophisticated technology and mission critical goods. Singapore Technologies Engineering, in which Temasek has a 50 percent interest, has more than 4,000 employees in the United States.

Through our portfolio companies we have had substantial experience with the domestic review process under the Committee on Foreign Investment in the United States. Temasek closely followed the process leading to the enactment of the new Foreign Investment and National Security Act last year. We are also closely following the process of writing regulations to guide the implementation of this law and the vigorous debate in Europe and the United States with respect to Sovereign Wealth Funds.

The United States and Singapore enjoy close economic and strategic relations. Annual bilateral trade has grown 41 percent from US$ 31.7 billion to US$44.7 billion since the 2003 Singapore-U.S. Free Trade Agreement. Today Singapore is the US's 15th largest trading partner. Companies like Singapore Airlines are major customers of American firms such as Boeing, General Electric and many others. On the strategic front, the Singapore Armed Forces is a major operator of U.S. military equipment, like the F-15 and F-16 aircraft, and is active in operations to reconstruct Iraq and Afghanistan. As a company headquartered in a small, vulnerable country located at a strategically important crossroads of Asia, Temasek understands and fully respects that the United States must take the measures necessary to protect its national security. Temasek fully appreciates and supports the Congress's goal to maintain the right balance in protecting national security in ways that continue the traditional welcoming attitude of the United States toward foreign investment.

**Mandate to Invest for Long Term Returns**

Let me take this opportunity to explain the history of Temasek and why we have come to operate commercially as part and parcel of our core philosophy.

> "One of the tragic illusions that many countries of the Third World entertain is the notion that politicians and civil servants can successfully perform entrepreneurial functions. It is curious that, in the face of overwhelming evidence to the contrary, the belief persists."
>
> Dr. Goh Keng Swee,
> Singapore Deputy Prime Minister
> *The Economics of Modernisation*, May 1972

In the years immediately after independence in 1965, the Government of Singapore co-invested in new enterprises in an effort to spur economic development and job creation. As a poor, newly independent nation-state on an island about the size of Lake Tahoe, with no natural resources and a population of less than 2 million, there was no choice but to ensure that such investments were commercially viable and sustainable. This imperative was pursued by Deputy Prime Minister Dr. Goh Keng Swee, who was the architect of Singapore's industrialization and economic development.

Dr. Goh's focus on commercially viable and sustainable investments was reinforced in 1974 when the Government of Singapore established Temasek and charged it with taking over the ownership and management of some 30 of these start-up investments. The creation of Temasek thus served to separate the regulatory and policy making function of the Government from its role as a shareholder of commercial entities. Temasek was and is, expected to manage its portfolio with commercial discipline.

Many of these start-up investments transferred into Temasek have been either fully or partially divested over the years, while Temasek continued to make other new investments. In addition, as the Government of Singapore streamlined some of its functions over the years, 6 such corporatized entities were transferred to Temasek with the Government again instructing Temasek to own and manage the companies on a commercial basis. These firms have included Singapore Telecommunications, which has since been publicly listed by Temasek; the former Public Works Department (renamed CPG Corporation), which Temasek has since sold to Downer Corporation of Australia; and, several power generating companies, which Temasek has

since methodically restructured to improve their operation and competitiveness, and is in the process of divesting over the next 12-18 months.

Throughout its history, Temasek has continued to invest and divest its portfolio based on its assessment of the long term value of the businesses, as part of its mandate to create and maximize long-term returns as an active investor and shareholder of successful enterprises.

In recent years, Temasek has focused on four investment themes:

- Transforming Economies
- Thriving Middle Class
- Deepening Comparative Advantages
- Emerging Champions

Essentially, Temasek is looking to invest in emerging long term trends. These would include economies in the process of transformation either through restructuring, market liberalization or improvements in governance, as well as outstanding companies with strong management which are in the process of change.

Temasek's growth over the years has been mainly funded through a combination of the growth of its portfolio companies, and returns from its direct investment/divestment activities. Temasek funds its investment activities predominantly from dividends distributed by its portfolio companies, proceeds from its divestments, commercial borrowings, a recent bond issue, and the occasional capital injection from its shareholder, the Ministry of Finance. Temasek does not

invest the foreign exchange reserves of Singapore. It pays cash dividends regularly to its shareholder and also pays taxes in the various jurisdictions in which it operates, like any other commercial entity.

Temasek's total shareholder returns since 1974, more than 33 years ago, is more than 18 percent compounded annually. This includes the appreciation in market value of Temasek's portfolio and dividends paid to our shareholder, less any net new capital into Temasek. This record speaks clearly of Temasek's focus on commercial discipline.

**Institutionalizing Good Governance**

Good governance is another key to the long term success of Temasek as an investor and shareholder of successful companies and investments. This is defined by our professionalism and robust internal processes, as well as the external relationships we have with our various stakeholders.

Under the Singapore Companies Act, all directors are charged with the fiduciary duty of acting in the best interest of their company and its shareholders. The eight-member Temasek board comprises mostly independent members, with independent, non-executive directors chairing the three key board committees. In addition, an 11-member Temasek International Panel of international business leaders and leading individuals provides the board and management with global perspective and advice on strategic matters. Two well-respected Americans who are familiar with market discipline are on the Panel: Mr. William J. McDonough (the vice-chairman of Merrill Lynch and the former president of the Federal Reserve Bank of

New York), and Mr. David Bonderman (the founder of leading private equity firm, Texas Pacific Group).

***With a disciplined governance and financial framework***

In addition, Temasek has in place a comprehensive framework for good governance and financial discipline. Temasek recognizes that a disciplined approach to investment and business decisions is the basis for sustaining shareholder returns over the long term. Temasek does this at two levels.

First, Temasek has a disciplined internal process, with the board delegating some level of investment authority to the management. The investment committee comprising the senior management team and other designated experienced management members will scrutinize and evaluate all investment proposals. Investment decisions within the authority limits of the investment committee will be made by the committee at a fortnightly meeting. Larger investments above this authority limit will either go to an Executive Committee of the Board or the full Board for their evaluation and approval. Minutes of their meetings and the decisions of both the investment committee and the Executive Committee are also circulated to the Board members. Where there is a conflict of interest, members will be recused from the discussion and deliberations of such meetings.

Second, Temasek recognizes the importance of disclosure as part of the discipline for financial rigor. We have of our own volition invited the continual scrutiny of our performance and investments by external, as well as knowledgeable international stakeholders through the

publication of an annual *Temasek Review*, through a credit rating by reputable international rating agencies and by issuing an international bond.

Audited annually by independent global accountancy firms, Temasek has published data on its financial performance in its annual *Temasek Review* since 2004. The report includes an overview of the firm's governance process, portfolio holdings by geography and sectors, significant investments and divestments made during the financial year, highlights of key developments and an indication of the firm's outlook and future directions. Temasek also maintains a website, www.temasek.com.sg, which contains access to current and previous annual reviews and up-to-date information of major developments. Temasek provides the full audited financial reports to its shareholder annually.

In addition, Temasek has been credit-rated by both Standard & Poor's and Moody's at the highest grade of AAA/Aaa respectively since 2005. It is one of the few AAA/Aaa rated firms in Asia. Apart from annual engagements with these rating agencies annually to review our performance results, every major Temasek transaction is scrutinized by these rating agencies. This process ensures that the firm's financial discipline and credit robustness remain intact.

Temasek also issued its maiden bond of US$1.75 billion in 2005, with detailed audited financial disclosures in compliance with US Securities and Exchange Commission regulations. This has served to include the global community of sophisticated investors as our interested stakeholders.

These voluntary undertakings for disciplined disclosures are part and parcel of Temasek's framework for institutionalizing sound financial discipline, and have contributed to Temasek's reputation as a well-governed, financially disciplined and transparent firm with full accountability.

***With our portfolio companies***

Temasek depends on the success of its portfolio companies to achieve sustainable long term returns. Temasek does not involve itself in the day to day business or operational decisions of its portfolio companies. For example, Temasek does not interfere with what aircraft Singapore Airlines should buy or which routes it should fly. Instead, Temasek emphasizes sound corporate governance with competent independent boards and professional management as the drivers for the long term success of outstanding companies. Temasek holds the respective board and management accountable for the performance of its portfolio companies, and exercises its full rights as a shareholder. Temasek contributes by referring effective candidates for Boards and key management positions for the consideration of the respective Boards and companies. Temasek also helps its portfolio companies in areas of good governance and management development in terms of executive programs and workshops on best practices and global trends.

As a shareholder, Temasek conducts its relations with its portfolio companies in accordance with best practices in corporate governance. As a principle, Temasek does not appoint nominees to fill board and chief executive positions, even in wholly-owned companies. Instead, by drawing from its international network of business contacts, Temasek prepares a shortlist of candidates for the portfolio company's board's consideration. The board may include

these candidates in its final search list, but makes its own independent decision for board members and/or chief executives. As any other shareholder, Temasek retains its right to vote on all corporate matters including board appointments.

***With the Government and the Elected President***

The relationship between Temasek and our sole shareholder, the Ministry of Finance, is similar to the relationship between Temasek and its portfolio companies. Temasek does not discuss its investment and divestment activities with the Government. The Constitution of Singapore reinforces the independence of the board and management of Temasek from financially imprudent interference by the Government.

To ensure fiscal discipline, the Singapore Constitution limits how the government of the day can use accumulated national reserves. It also empowers the President -- elected directly by Singaporeans every six years - to oversee the management of national reserves. (The President of Singapore plays a very different role in Singapore's system than the President of the United States plays in the US system. The President of Singapore is a non-Executive and sits apart from the Government and cannot be a member of any political party or engage in any commercial enterprise.)

The Constitution limits the Government to using surpluses accumulated during its current term of office. Each election heralds a new term of government, and any surpluses at the change of government are locked up as past reserves. To draw on past reserves accumulated by

preceding administrations, approval must be sought from the President. This aims to prevent a profligate government from wasting away past reserves.

Similarly, Temasek is one of the important state-owned companies designated under the Singapore Constitution to have the additional oversight by the President of Singapore. This is due to the significant pool of capital which Temasek has successfully grown and accumulated since its inception. Hence, while the Ministry of Finance is Temasek's shareholder, the President must also concur with the appointment, renewal and removal of Temasek's directors and chief executive. This provides the Board and Management another layer of insulation from undue Government influence.

**Corporate Citizenship**

As a responsible long term investor, Temasek is active in contributing to the larger community in various ways. In particular, Temasek believes in supporting efforts to build people and to build bridges among peoples. It regularly contributes to various philanthropic efforts, particularly in Asia, including in education, research, and cross-border exchange programs, to build resilience and foster self reliance.

As part of its long term commitment to the wider community, it has also been putting aside a share of its economic profit since 2003, and formalized its commitment by launching the Temasek Trust with an initial endowment of S$500 million (US$350 million). In turn, the Trust has supported various non-profit philanthropic organizations. Noteworthy among these is the Temasek Foundation which has a mandate to fund social investments to help build up the

capabilities and capacities of people around Asia, build understanding, friendship and trust between the diverse people of the world, build outstanding institutions by promoting good governance and ethics, and to rebuild lives after natural disasters such as the tsunami of December 2006.

Among Temasek's various longstanding initiatives, the Temasek LifeSciences Laboratory has been closely involved in developing low-cost, easy to use diagnostic kits for identifying bird flu in emerging countries, particularly in Asia. This is part of our community support in the event of a major pandemic, where there is a need to have kits which do not require sophisticated logistics such as refrigeration, and village midwives can be quickly trained to provide frontline diagnosis through simple to use kits.

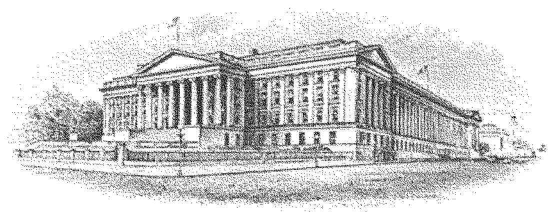
At the other end of the spectrum, Temasek has sponsored the setting up of the Wealth Management Institute, which has helped train and develop the next generation of financial talents. This effort included scholarships for professionals, students, bankers and regulators from around the world.

In addition, Temasek operates on a firm philosophy of not just benefiting from our investments, but also contributing to the larger community through our investments. For instance, Temasek has been an active supporter of microfinance, in providing microcredit through simple and convenient ways to service the under-served lower income groups in Asia. Successful programs targeting micro- and small-scale enterprises as well as self-employed individuals have been rolled out in Indonesia (~730 branches) and India (~620 branches), and is

currently in a pilot phase in Pakistan (~15 branches). Many of these enterprises and individuals have never been served by the formal banking sector before. The presumption is that such credit access helps lower income earners improve their lives, and thus help contribute towards a stable and growing middle class. Such successful initiatives also help create viable jobs both within the banking sector as well as in the larger communities.

**Summary**

Temasek's course was set over thirty years ago when Temasek was incorporated as a commercial company to hold and manage its assets and to invest commercially. As Temasek grows and increasingly diversifies its global portfolio, it is mindful that its success has been rooted in the commercial principles and strong governance which have served it well. It is committed to operate as a trusted and thoughtful business partner, and a reliable long term shareholder and careful investor with a strong reputation and track record for integrity and good governance.



# U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 2:15 p.m. (EST), March 5, 2008
CONTACT John Rankin, (202) 622-1343

## UNDER SECRETARY FOR INTERNATIONAL AFFAIRS DAVID H. MCCORMICK TESTIMONY BEFORE THE COMMITTEE ON FINANCIAL SERVICES

## SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY AND SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

WASHINGTON – Chairman Gutierrez, Chairman Kanjorski, Ranking Member Paul, Ranking Member Pryce, Members of the Committee, good afternoon. I very much appreciate the opportunity to appear before you today to discuss sovereign wealth funds. This is a timely hearing on a very important topic. At Treasury, we have been increasingly focused on sovereign wealth funds for more than a year now. I am pleased to be able to share with the Committee some of our views.

**History and Context**

Although the term "sovereign wealth fund" was coined just a few years ago, the funds it describes are not new. Sovereign wealth funds have existed in various forms for decades in places as diverse as the central Pacific, Southeast Asia, Europe and the Persian Gulf. At the turn of the century, there were about 20 sovereign wealth funds worldwide managing total assets of several hundred billion dollars.

Today, what is new is the rapid increase in both the number and size of sovereign wealth funds. Twenty new funds have been created since 2000, more than half of these since 2005, which brings the total number to nearly 40 funds that now manage total assets in a range of $1.9-2.9 trillion. Private sector analysts have projected that sovereign wealth fund assets could grow to $10-15 trillion by 2015. Two trends have contributed to this ongoing growth. The first is sustained high commodity prices. The second is the accumulation of official reserves and the transfers from official reserves to investment funds in non-commodity exporters. Within this group of countries, foreign exchange reserves are now sufficient by all standard metrics of reserve adequacy. For these non-commodity exporters, more flexible exchange rates are often necessary, and Treasury actively pushes for increased flexibility.

So what are sovereign wealth funds? At the Department of the Treasury, we have defined them as government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves. Sovereign wealth funds generally fall into two categories based on the source of the foreign exchange assets:

- Commodity funds are established through commodity exports, either owned or taxed by the government. They serve different purposes, including stabilization of fiscal revenues, intergenerational saving, and balance of payments sterilization. Given the recent extended sharp rise in commodity prices, many funds initially established for fiscal stabilization purposes have evolved into savings funds. In the case of commodity funds, foreign currency typically accrues to the government and does not increase the money supply and create unwanted inflationary pressure.

- Non-commodity funds are typically established through transfers of assets from official foreign exchange reserves. Large balance of payments surpluses have enabled non-commodity exporting countries to transfer "excess" foreign exchange reserves to stand-alone funds. In the case of non-commodity funds, foreign exchange assets often derive from exchange rate intervention, which then increases a country's money supply. Monetary authorities take additional steps to lower the money supply and stave off inflation by issuing new debt, but there may be a cost associated with this if the cost of the new debt is more than the returns that the government earns on its foreign exchange assets.

In contrast to traditional reserves, which are typically invested for liquidity and safety, sovereign wealth funds seek a higher rate of return and may be invested in a wider range of asset classes. Sovereign wealth fund managers have a higher risk tolerance than their counterparts managing official reserves. They emphasize expected returns over liquidity, and their investments can take the form of stakes in U.S. companies, as has been witnessed in recent months with increased regularity.

However, sovereign wealth fund assets are currently fairly concentrated. By some market estimates, a handful of funds account for the majority of total sovereign wealth fund assets. Roughly two-thirds of sovereign wealth fund assets are commodity fund assets ($1.3-1.9 trillion), while the remaining one-third are non-commodity funds transferred from official reserves ($0.6-1.0 trillion).

To get a better perspective of the relative importance of sovereign wealth funds, it is useful to consider how they measure up against private pools of global capital. Total sovereign wealth fund assets of $1.9-2.9 trillion may be small relative to a $190 trillion stock of global financial assets, or the roughly $62 trillion managed by private institutional investors. But sovereign wealth fund assets are currently larger than the total assets under management by either hedge funds or private equity funds and are set to grow at a much faster pace.

In sum, sovereign wealth funds represent a large and rapidly growing stock of government-controlled assets, invested more aggressively than traditional reserves. Attention to sovereign wealth funds is inevitable given that their rise clearly has implications for the international financial system. Sovereign wealth funds bring benefits to the system but also raise potential concerns.

**Benefits**

A useful starting point when discussing the benefits of sovereign wealth funds is to stress that the United States remains committed to open investment. On May 10, 2007, President Bush publicly reaffirmed, in his Statement on Open Economies, the U.S. commitment to advancing open economies at home and abroad, including through open investment and trade. Lower trade and investment barriers benefit not only the United States, but also the global economy as a whole. The depth, liquidity and efficiency of our capital markets should continue to make the United States the most attractive country in the world in which to invest.

In 2006, there was a net increase of $2.5 trillion in foreign-owned assets in the United States, while U.S. net international investment abroad increased by $2.2 trillion. International investment in the United

States fuels U.S. economic prosperity by creating well-paid jobs, importing new technology and business methods, helping to finance U.S. priorities, and providing healthy competition that fosters innovation, productivity gains, lower prices, and greater variety for consumers. Over five million Americans –
4.6 percent of the U.S. private sector – are employed by foreign-owned firms' U.S. operations. Over 39 percent of these five million jobs at foreign-owned firms are in manufacturing, a sector that accounts for 13 percent of U.S. private sector jobs. These five million jobs pay 25 percent higher compensation on average than jobs at other U.S. firms. Another roughly five million jobs are indirectly supported by foreign investment. Additionally, foreign-owned firms contributed almost six percent of U.S. output and 14 percent of U.S. R&D spending in 2006. Foreign-owned firms re-invested over half of their U.S. income – $71 billion – back into the U.S. economy in 2006. A disproportionate 13 percent of U.S. tax payments and 19 percent of U.S. exports are made by foreign-owned firms. Without international investment, Americans would be faced with painful choices regarding taxes, spending on government programs, and their level of savings and consumption. Another benefit of FDI is that foreign investors' economic interests become more dependent on the health of the U.S. economy – giving the investor an incentive to support U.S. economic interests.

As many observers have pointed out, sovereign wealth funds have the potential to promote financial stability. They are, in principle, long term, stable investors that provide significant capital to the system. They are typically not highly leveraged and cannot be forced by capital requirements or investor withdrawals to liquidate positions rapidly. Sovereign wealth funds, as public sector entities, should have an interest in and a responsibility for financial market stability.

**Potential Concerns**

Yet, sovereign wealth funds also raise potential concerns.

First, transactions involving investment by sovereign wealth funds, as with other types of foreign investment, may raise legitimate national security concerns. The Committee on Foreign Investment in the United States (CFIUS), which is chaired by Treasury, conducts robust reviews of certain investments that could result in foreign control of a U.S. business to identify and resolve any genuine national security concerns. The Foreign Investment and National Security Act (FINSA) became effective on October 24, 2007, and strengthened the CFIUS process. CFIUS is able to review investments from sovereign wealth funds, just as it would other foreign government-controlled investments, and it has and will continue to exercise this authority to ensure national security. CFIUS reviews are of course limited to identifying and resolving genuine national security concerns.

Separately, Treasury is also considering non-national security issues related to potential distortions from a larger role of foreign governments in markets. Through inefficient allocation of capital, perceived unfair competition with private firms, or the pursuit of broader strategic rather than strictly economic return-oriented investments, sovereign wealth funds could potentially distort markets. Sovereign wealth funds may also indirectly invest abroad through domestic state-owned enterprises. However, such action by a SWF is more likely to be viewed as a direct extension of government policy. Clearly, both sovereign wealth funds and the countries in which they invest will be best served if investment decisions are made solely on commercial grounds.

The investment policy issues I have just described – both the national security and non-national security issues – have the potential to provoke protectionist responses from recipient country governments. It is my view that protectionist sentiment stems partly from a lack of information and understanding of sovereign wealth funds, which in turn is partly due to a lack of transparency and clear communication on the part of many of the funds themselves. Further, concerns about cross-border investment by state-

owned enterprises are often misdirected at sovereign wealth funds as a group. Better information and understanding on both sides of the investment relationship is therefore needed.

Finally, sovereign wealth funds may raise concerns related to financial stability. Sovereign wealth funds can represent large, concentrated, and often non-transparent positions in certain markets and asset classes. Actual shifts in their asset allocations can cause market volatility. In fact, even perceived shifts or rumors can cause volatility as the market reacts to what it perceives sovereign wealth funds to be doing.

**Policy Response**

Treasury has taken a number of steps to help ensure that the United States can continue to benefit from open investment while addressing these potential concerns.

First, we are aggressively implementing reforms that strengthen the CFIUS process, reflected in FINSA and Executive Order 11858, issued by the President on January 23. We are proceeding steadily through a vigorous drafting process for new regulations which will become effective later this Spring following public notice and comment. One of the reforms codified by FINSA, which we have already implemented, is an elevated level of accountability within CFIUS for review of foreign government-controlled transactions. I want to be clear that CFIUS has – as early as 1989 – and will continue to review the investment transactions of sovereign wealth funds, based on the consideration of genuine national security concerns, just as it does for other foreign government-controlled investment. FINSA protects our national security while keeping investment barriers low and reaffirming investor confidence and the longstanding U.S. open investment policy. CFIUS will continue to vigorously implement this law.

Second, we have proposed that the international community collaborate on the development of a multilateral framework for best practices. The International Monetary Fund, with support from the World Bank, should develop voluntary best practices for sovereign wealth funds, building on existing best practices for foreign exchange reserve management. These would provide guidance to new funds on how to structure themselves, reduce any potential systemic risk, and help demonstrate to critics that sovereign wealth funds can be responsible, constructive participants in the international financial system.

Here, I would note that the logic of voluntary best practices for sovereign wealth funds is to create a dynamic rise to the top. International agreement on a set of best practices will create a strong incentive among funds to hold themselves to high standards. Sovereign wealth funds themselves are increasingly aware that the increase in the number and size of these funds has, rightly or wrongly, raised reputational issues for them all.

Third, we have proposed that the Organisation for Economic Co-operation and Development (OECD) should identify best practices for countries that receive foreign government-controlled investment, based on its extensive work on promoting open investment regimes. These should have a focus on avoiding protectionism and should be guided by the well-established principles embraced by OECD and its members for the treatment of foreign investment.

We have already seen meaningful progress along these lines. On May 12-13 of last year, Treasury hosted a G-20 meeting of Finance Ministry and Central Bank officials on commodity cycles and financial stability, which included perhaps the first multilateral discussion of sovereign wealth funds among countries with these funds and countries in which they invest. Following a period of extensive direct bilateral outreach with sovereign wealth funds, Secretary Paulson hosted a G-7 outreach meeting on October 19, 2007 with Finance Ministers and heads of sovereign wealth funds from eight countries

(China, Korea, Kuwait, Norway, Russia, Saudi Arabia, Singapore, and the United Arab Emirates) to build support for best practices.

On October 20, 2007, the International Monetary and Financial Committee – a ministerial level advisory committee to the IMF – issued a statement calling on the IMF to begin a dialogue to identify best practices for sovereign wealth funds. On November 15-16, 2007, the IMF hosted a roundtable meeting for sovereign asset and reserve managers. In response to the IMFC statement, the IMF added a special session on policy and operational issues relating to SWFs for official sector delegates. This marks the beginning of an important process in the IMF. IMF Managing Director Dominique Strauss-Kahn opened the roundtable meeting and underlined that some form of agreement on best practices for the operations of SWFs could help maintain an open global financial system.

A separate dialogue is well underway in the OECD on investment policy issues with regard to SWFs, building on the discussions on Freedom of Investment, National Security, and "Strategic" Industries. Later this month, the OECD Investment Committee will discuss an interim report on broader investment issues that will also cover SWFs. The OECD expects to issue a "special statement" regarding investment policy principles and sovereign investment at its June Ministerial.

Fourth, Treasury has taken a number of steps internally and within the U.S. Government to enhance our understanding of sovereign wealth funds. Treasury has created a working group on sovereign wealth funds that draws on the expertise of Treasury's offices of International Affairs and Domestic Finance. Treasury's new market room is ensuring vigilant, ongoing monitoring of sovereign wealth fund trends and transactions. Through the President's Working Group on Financial Markets, chaired by Secretary Paulson, we continue to discuss and review sovereign wealth funds. We have also engaged sovereign wealth funds directly on numerous occasions, at numerous levels within our government and at numerous forums.

Treasury is actively coordinating with Congress through staff briefings and committee hearings. As you may know, I testified on these issues before the Senate Banking Committee in November. Also, in June and December of last year we provided Congress with updates on our sovereign wealth fund-related work in an appendix to the Report on International Economic and Exchange Rate Policies, and we will continue to provide updates on a semi-annual basis.

The Treasury Department will continue its work on sovereign wealth funds through sound analysis and focused bilateral and multilateral efforts to help ensure the United States shapes an appropriate international response to this issue, addresses legitimate areas of concern, and together with other countries, remains open to foreign investment.

**Statement by**

Director General Martin Skancke, Asset Management Department, Norwegian Ministry of Finance[1]

**Before**

The subcommittee on Domestic and International Monetary Policy, Trade and Technology and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

The Committee on Financial Services
U.S. House of Representatives

**Hearing on**

**"Foreign Government Investment in the U.S. Economy and Financial Sector"**

March 5th 2008

[1] The departments of the Norwegian Ministry of Finance are each headed by a Director General. These are non-political civil servant positions.

*Introduction*
Thank you for the invitation to address these distinguished subcommittees on issues related to Sovereign Wealth Funds and their investments in the United States.

The Norwegian Government Pension Fund – Global (PFG) was formally established in 1990 – under the name "The Government Petroleum Fund" – as a tool to support a prudent management of petroleum revenues. Since the first net transfer in 1996, the Fund has grown rapidly in size. The Fund currently has assets of around 2,000bn NOK, which is equivalent to some 375bn USD, making it one of the largest single-owned funds in the world. One third of the portfolio, about 125 bn USD, is invested in bonds and equities in the US market. The US is by far the largest recipient country for our investments. The Fund is envisaged to grow substantially in coming years, and is estimated to reach NOK 3 500bn by the start of the year 2012, or approximately USD 600bn, see chart 1.

The Fund has a twofold purpose of smoothing out the spending of volatile oil revenues, and at the same time acting as a long-term savings vehicle allowing the Norwegian government to accumulate financial assets in order to help cope with large, future financial commitments associated with an ageing population. To effectively shield the non-oil economy from the effects of a volatile flow of foreign currency earnings from the oil sector, the Fund is only invested abroad. The allocations to and withdrawals from the Fund are fully integrated with the Fiscal Budget, see chart 2.

Accumulation of capital in the Fund reflects the depletion of a non-renewable resource, which is exchanged for financial assets through the Fund's investments. This is true of many of the Sovereign Wealth Funds in the world today, including the SWF in the US, The Alaska Permanent Fund.

A sensible management of oil-producing countries' petroleum wealth in well-functioning financial markets is in everyone's interest. Well-functioning international financial markets are mutually beneficial as they give capital importers the opportunity to finance productive investments without reducing current consumption and capital exporters the chance to smooth consumption over time and achieve higher risk-adjusted returns. The experience of the 1970s, with large-scale recycling of oil revenues by oil producing countries through the international banking system, shows that a more diversified investment approach, also including equity investments, is desirable.

It can also be noted that the separation of spending of petroleum revenues from the current revenue stream through a fund mechanism allows Norway – and other oil producing countries – to extract petroleum at a higher rate than would be advisable if all the proceeds were to be allowed into the domestic economy on a continuous basis. Conversely, if investments of oil-related SWFs in international financial markets are restricted, the relative attractiveness of saving in the form of keeping oil in the ground would increase. Hence the petroleum funds do not just offer an attractive way of recycling the revenues of the oil producers in international financial markets; they can also have an indirect stabilizing effect on the oil market.

*The Fund's investments*
The Fund is invested globally in a wide range of financial instruments, in order to get a broad diversification and achieve good investment returns with moderate financial risk. The Fund is a pure financial investor with small ownership shares in over 7000

individual companies worldwide. The strategic asset allocation is currently 60 pct. equities and 40 pct. fixed income. Within each asset class the Fund's investments are spread out across the world's financial markets according to the regional weights of the strategic benchmark and the weights of the various securities in the chosen market indices, see figure 3.

The investment strategy has evolved over time. As the fund has grown in size, the time horizon of the investments has also increased. A new fiscal policy rule was introduced in 2001, stipulating that the withdrawals from the Fund to cover the non-oil budget deficit over time should correspond to the estimated real return of the Fund. As long as this rule is adhered to, the capital of the Fund is preserved in real terms (but not as a share of GDP) indefinitely, making the Fund function like an endowment with an investment horizon which in principle is infinite. This has made it more appropriate to consider less liquid and somewhat more risky ways of investing the Fund's assets. The largest change recently was last year, when it was decided to increase the equity portion of the Fund from 40 pct. to 60 pct. Including real estate in the Fund's strategic benchmark is under consideration.

We believe the Fund has a positive influence on international financial markets through enhancing market liquidity and financial resource allocation. The Fund has a long investment horizon, no leverage and no claims for the imminent withdrawal of funds. The portfolio is rebalanced regularly, to bring actual portfolio weights in line with the stipulated strategic weights. The Fund will therefore generally be buying equities when equity prices are in relative decline, and vice versa. This also constitutes a stabilizing factor in financial markets.

*Governance structure*

The governance structure of the Fund is marked by a clear division of responsibilities between the political authorities and the operational management, see figure 4. Under the Pension Fund Act, the Ministry of Finance is the formal owner of the Fund. However, all significant changes to the Fund's investment strategy are in practice presented to Parliament before implementation as a way of ensuring broad political support for important strategic choices.

The Fund is formally an account the Ministry of Finance has in Norges Bank (The Norwegian Central Bank). Norges Bank has invested the corresponding value of the account in international financial markets in its own name through the fund management division of the Bank, Norges Bank Investment Management (NBIM). Norges Bank is thus the formal owner of the foreign assets of the Fund. The value of the Ministry's account in the Bank is set equal to the market value of the corresponding pool of foreign assets held by the Bank. The Ministry therefore bears the risk of changes in the market value of the assets.

The Ministry has formulated the investment strategy for the Fund by setting a clearly defined and transparent benchmark with risk limits. Within these limits, there is full delegation of operational management to Norges Bank. The Bank manages parts of the funds internally, while parts are managed by external managers appointed by the Bank on a commercial basis. Norges Bank is as formal owner of the assets also charged with exercising the Fund's ownership rights.

The Ministry of Finance established Ethical Guidelines for the Fund in 2004 based on a broad political consensus. The Ethical Guidelines' paramount objectives are sound financial returns, along with the obligation to respect fundamental rights of those who are affected by the companies in which the Fund invests. The Ethical Guidelines are transparent and predictable, and are based on internationally recognized standards, such as the UN Global Compact and the OECD Guidelines for Multinational Enterprises.

Two policy instruments – the exercise of ownership rights and exclusion of companies – are prescribed as tools to promote the ethical commitments of the Fund. It is emphasized that ownership interests in the companies in which the Fund invests are exercised with a view to safeguard the long-term financial interests of the Fund. The guidelines are based on the view that there is a link between sustainable economic development and sustainable social and environmental development, so that the Fund in the long run as a very diversified investor with a long time horizon will benefit from companies respecting fundamental ethical norms.

Institutional funds in general, and funds owned by governments in particular, face specific challenges. While individual shareholders may sell their holdings of individual assets or funds they do not find ethically acceptable, the citizens of Norway have to accept to be the ultimate owners of the companies that the Fund invests in. To preserve the legitimacy of the Fund, it is important that the ownership in the various companies is acceptable for most citizens. Hence, the Fund avoids investments in companies whose practices constitute an unacceptable risk that the Fund is or will be complicit in what is deemed as grossly unethical activities. The decision to exclude a company from the Fund's investment universe ultimately rests with the Ministry of Finance, but are based on publicly available recommendations from an independent Council on Ethics for the Fund, see figure 5. This should not be misrepresented as undue political interference with the Fund's investments. It is a necessary measure – based on principles of transparency and fairness – to ensure support and legitimacy for a fund which is a cornerstone of macroeconomic policy, and which presently is accumulating assets at a rate corresponding to 15-20 pct. of Norwegian GDP per year. As of February 2008, the Ministry has excluded a total 27 companies from the investment universe of the Fund, primarily as a consequence of the exclusion of some forms of weapons production, i.a. cluster bombs, land mines and nuclear weapons.

*Transparency and the international work on SWFs*

Key factors in the management of the Norwegian Fund include a high degree of transparency in all aspects of its purpose and operation, the Fund's role as a financial investor with non-strategic holdings, an explicit aim to maximise financial returns, and clear lines of responsibility between political authorities and the operational management. Norges Bank presents financial reports for the fund every quarter. The Bank has also published its priorities in the field of corporate governance. A full list of every single asset held by the Fund is published annually, and with effect from 2007, a full list is also published of how the Bank has voted on every issue in every company where it has exercised this right, comprising almost 40 000 issues in more than 4 000 companies. The Ministry of Finance presents an annual report to the Norwegian Parliament, giving detailed information on returns and a broad discussion of issues related to investment strategy and the implementation of the ethical guidelines. Most of the information is given both in Norwegian and English.

A high degree of transparency is essential to be able to build and maintain support for the Government's management of the petroleum wealth, which entails running large budget surpluses and building up substantial and very visible financial assets. Openness about the fund management may also contribute to stable international financial markets. Other market participants will then be familiar with our investment strategy and circumstances, thereby facilitating well-functioning financial markets. Furthermore, transparency provides a disciplinary effect on the fund management. As fund performance is subjected to public scrutiny, managers of sovereign wealth are met with pressures to deliver sound financial returns.

Thus we are of the opinion that a high degree of transparency does not compromise the return of our Fund. However, our investment strategy has focused on well diversified financial investments in highly liquid markets. Costs of transparency can be higher for a strategic investor in less liquid markets.

In the international debate on Sovereign Wealth Funds, transparency has become a central issue. Transparency is an abstract concept, and we perhaps need a more granular approach to the subject of increased transparency if we are to make progress in this area. Hence there is a need to better define the concept of transparency and which elements of disclosure that will be necessary to best serve well-functioning markets.

It may in this regard prove useful to distinguish between three different areas of transparency.

- Governance structure: Who are the ultimate owners of a fund, who makes investment decisions, what are the arrangements for audit, supervision and control?
- Investment objectives: What is the purpose of the fund, the time horizon for investments, the rules governing allocations to and withdrawals from a fund?
- Investment strategy and implementation: What is the size of the fund, the asset composition, risk limits and returns?

Transparency about governance structure and investment objectives would be helpful steps to alleviate concerns about Sovereign Wealth Fund investments.

Transparency on investment strategy and implementation would probably need to reflect the characteristics of the investor. Claims for increased transparency have to be balanced against legitimate business interests of investors. Whilst the Norwegian Fund is characterized by a high degree of transparency, there are certain aspects in the management of the Fund that, based on pure business considerations, are not made public. There are risks associated with deploying considerable amounts of capital into the financial markets. The disclosure of the exact timing and procedure of fund allocations in advance of the relevant actions could have adverse pricing effects in the markets. There is a need to strike a balance – also for us – between the need for transparency and on the other hand to use business sense and not be put at a disadvantage in the market.

Transparency also has to run both ways. If recipient countries set up screening processes to address legitimate national security concerns, there must be transparency with respect to how such screening decisions are made, by whom and under which criteria. Lack of transparency in this area can lead to suspicions of financial protectionism, introduce an

element of uncertainty to the investment process, reduce investor confidence, and may ultimately reduce the relative attractiveness of non-transparent recipient countries.

Even a transparent process may reduce the relative attractiveness of a market if foreign sovereign investors have to undergo a lengthy formal process that puts them at a disadvantage compared with domestic investors or other foreign investors.

We support the ongoing work in the IMF and the OECD in studying the effects of Sovereign Wealth Funds (SWF). Any work on developing a set of best practices should be carried out by the IMF, with the collaboration of relevant partners. In this respect, we welcome the constructive approach of the EU commission as presented in their paper of February 27th. However, we see no cause for regulations that would restrict the present investment activities of our Fund, or any regulation imposing restrictions on SWF over and above those applying to non-SWF investors.

Apart from restrictions applying to very limited cases concerning national security, we must respect freedom of investment and equal treatment of shareholders as a fundamental principle. The declaration from the G8-summit on 7 June 2007 in Heiligendamm expressed what would seem to be a sound principle: "...we remain committed to minimize any national restrictions on foreign investment. Such restrictions should apply to very limited cases which primarily concern national security."

*Corporate governance in the US*
I note that there are some questions related to regulatory framework and corporate governance in the invitation to this hearing. While these are very timely and important questions, they primarily fall under the responsibility of Norges Bank as investor and formal owner of the Fund's assets. In keeping with our strict adherence to proper separation of responsibilities, let me just make some general remarks on this issue and refer you to the views of Norges Bank as published in their annual report yesterday.

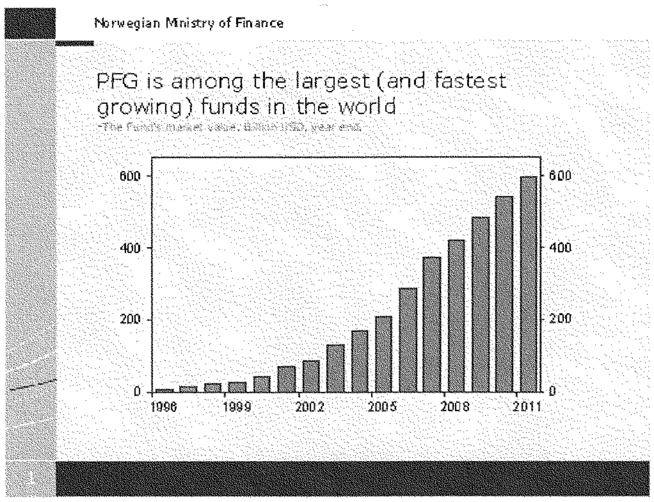
The Norwegian Pension Fund has a very long time horizon, and will in principle be permanently invested in global capital markets. It is in the Fund's financial interest that the companies it invests in are well-run, profitable and operate in well-functioning markets. A sound regulatory framework and good corporate governance arrangements are important preconditions for this.

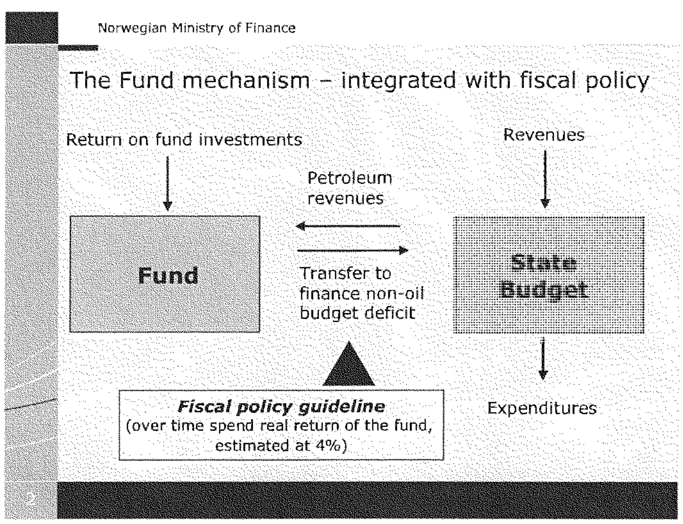
Norges Bank has chosen to concentrate its corporate governance work on a small number of priority areas which are of particular importance for the long-term returns of the Fund. The Bank has, in collaboration with other large institutional European investors (Hermes, ABP and PGGM), entered into a dialogue with US authorities on the subject of shareholder rights in US listed companies. Norges Bank observes that a lack of accountability, still faced in many corporations, constitutes a source of risk. Further, it notes that shareholder influence in the composition of boards helps to build a proper system of checks and balances between managers (agents) and the board representing the principal. In this regard, further progress on the accountability of corporate boards will yield a positive effect on the attraction of the US market for international investors. In its annual report for 2007, Norges Bank notes progress on some corporate governance issues it has raised with US authorities, but simultaneously expresses concern about lack of progress in other areas.

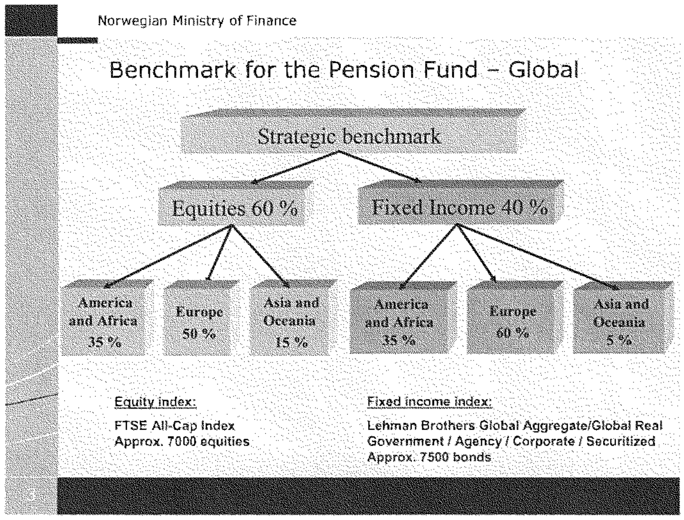
I trust that you will interpret this as a gentle encouragement of further strengthening the already high standing of US financial markets.

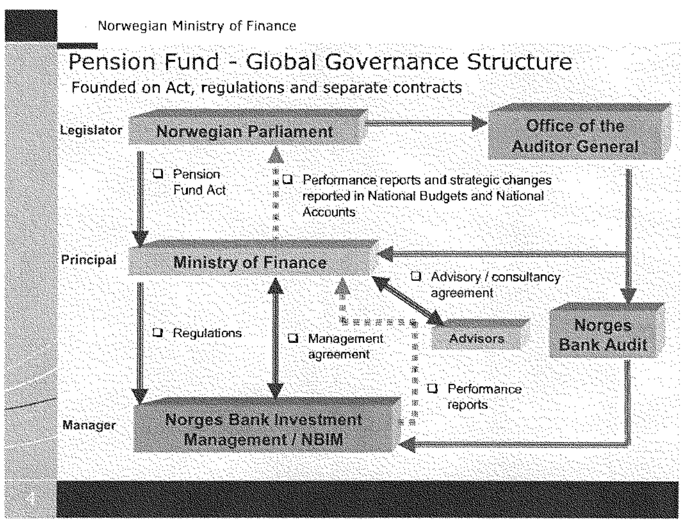
I will be more than willing to answer any questions you might have. Thank you.

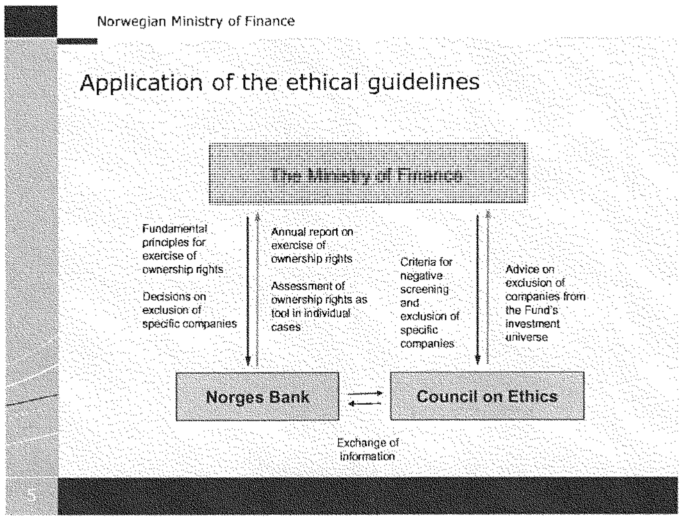
## Charts


Norwegian Ministry of Finance
PFG is among the largest (and fastest growing) funds in the world
600
400
200
0
1996
1999
2002
2005
2008
2011


Norwegian Ministry of Finance
The Fund mechanism – integrated with fiscal policy
Return on fund investments
Revenues
Petroleum revenues
Fund
Transfer to finance non-oil budget deficit
State Budget
Fiscal policy guideline
(over time spend real return of the fund, estimated at 4%)
Expenditures


Norwegian Ministry of Finance
Benchmark for the Pension Fund – Global
Strategic benchmark
Equities 60 %
Fixed Income 40 %
America and Africa 35 %
Europe 50 %
Asia and Oceania 15 %
America and Africa 35 %
Europe 60 %
Asia and Oceania 5 %
Equity index:
FTSE All-Cap Index
Approx. 7000 equities
Fixed income index:
Lehman Brothers Global Aggregate/Global Real
Government / Agency / Corporate / Securitized
Approx. 7500 bonds
3


Norwegian Ministry of Finance
Pension Fund - Global Governance Structure
Founded on Act, regulations and separate contracts
Legislator
Norwegian Parliament
Office of the Auditor General
Pension Fund Act
Performance reports and strategic changes reported in National Budgets and National Accounts
Principal
Ministry of Finance
Advisory / consultancy agreement
Regulations
Management agreement
Advisors
Norges Bank Audit
Performance reports
Manager
Norges Bank Investment Management / NBIM
4


Norwegian Ministry of Finance
Application of the ethical guidelines
The Ministry of Finance
Fundamental principles for exercise of ownership rights
Decisions on exclusion of specific companies
Annual report on exercise of ownership rights
Assessment of ownership rights as tool in individual cases
Criteria for negative screening and exclusion of specific companies
Advice on exclusion of companies from the Fund's investment universe
Norges Bank
Council on Ethics
Exchange of information

# Appendix:

## Fact-sheet on the Government Pension Fund – Global
(Formerly known as the Government Petroleum Fund)

**History**
1969: Petroleum discovered in the North Sea (Ekofisk), production start in 1971.
1990: Parliament passed the Government Petroleum Fund law.
1996: First net transfer to the Fund. Invested like Central Bank currency reserves.
1998: Investment in equities introduced in the benchmark (40% allocation).
2000: Five emerging market countries added to the equity benchmark.
2002: Non-government bonds added to the fixed income benchmark.
2004: New ethical guidelines.
2006: The Government Petroleum Fund renamed the Government Pension Fund – Global.
2007: Strategic equity allocation increased to 60%, small-cap stocks included in benchmark.

**Purpose**
The Petroleum Fund was established in 1990 as a fiscal policy tool to support a long-term management of the petroleum revenues. Renaming the Fund to the Pension Fund - Global in 2006 was part of a broader pension reform, highlighting also the Fund's role in facilitating government savings necessary to meet the rapid rise in public pension expenditures in the coming years. The Fund is not earmarked for pension expenditures.

**"The Norwegian petroleum fund model" in a nutshell**
- The Fund is fully integrated into the state budget. It functions as a tool to strengthen the budget process and builds on existing institutions.
- The Fund is only invested abroad in financial assets. This ensures risk diversification and good financial returns, and helps to protect the non-oil economy.
- There is a high degree of transparency and disclosure of information. This helps build public support for a wise management of petroleum revenues, and reduces the risk of bad governance.

**Key Design Features**
- The Fund's inflow consists of all state petroleum revenues, net financial transactions related to petroleum activities, as well as the return on the Fund's investments.
- The outflow from the Fund is the sum needed to cover the non-oil budget deficit.

This means that the Fund is fully integrated into the state budget and that net allocations to the Fund reflect the total budget surplus (including petroleum revenues). Fiscal policy, which regulates the outflow from the Fund, is anchored in the guideline that over time the structural, non-oil budget deficit shall correspond to the real return on the Fund, estimated at 4%.

**Governance**
- The Ministry of Finance is responsible for the management of the Fund.
- The operational management is carried out by Norges Bank (the Central Bank), which invests the Fund in accordance with guidelines issued by the Ministry.
- Key changes to investment guidelines are presented to Parliament before implemented.
- The Ministry receives advice on the investment guidelines from Norges Bank, the Ministry's advisory council on investment strategy and external consultants.
- The Ministry uses external consultants for independent performance measurement and benchmarking of performance and costs.

**Investment Guidelines**
- The investment strategy is to achieve high financial returns subject to moderate risk.
- The Fund is only invested abroad in financial instruments. The fund is a financial investor with a diversified portfolio of non-strategic holdings in a range of companies.

- The Fund's financial results are primarily assessed in international currency terms, in order to gauge the development in the Fund's international purchasing power.
- Equities account for 60% of the Fund's strategic benchmark portfolio, consisting of equities listed on exchanges in Europe (50%), America/Africa (35%) and Asia/Oceania (15%).
- Fixed income instruments account for 40% of the strategic benchmark portfolio, consisting of fixed income instruments issued in currencies from Europe (60%), America/Africa (35%) and Asia/Oceania (5%).

**Ethical Guidelines**
The ethical guidelines for the Fund are based on the recommendations of the Graver Commission (NOU 2003:22). The guidelines have two main elements:

- The Fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations, and it is an ethical obligation for present generations to manage it so as to generate a sound return.
- The Fund should not make investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages.

To implement the ethical guidelines, the following mechanisms are employed:

- Manage the Fund well so as to achieve high returns subject to moderate risk.
- Exercise the ownership rights associated with the equity holdings (done by Norges Bank).
- Exclude some companies from the Fund's investment universe (decided by the Ministry based on advice from a Council on Ethics). Exclude some government bonds from the investment universe (decided by the Ministry).

**Transparency**
The management of petroleum revenues in general and the Fund in particular is characterised by a high degree of transparency and disclosure of information.

- The Ministry reports to Parliament on all important matters relating to the Fund, such as the size of petroleum revenues and the Fund; the outlook for fiscal sustainability; changes to the investment strategy; the Fund's performance, risk and costs.
- The Ministry publishes advice and reports received from Norges Bank, the Strategy Council and external consultants.
- Norges Bank publishes quarterly reports on the management of the Fund, as well as an annual report and an annual listing of all investments.

**Key numbers**

| | 2005 | 2006 | 2007 | 1998-2007 |
|---|---|---|---|---|
| Size in NOK bn | 1 399 | 1 784 | 2 019 | |
| Size in USD bn | 207 | 285 | 380 | |
| Total return in % (in FX basket) | 11.1 | 7.9 | 4.3 | 6.0 |
| ...of which manager excess return | 1.1 | 0.2 | -0.2 | 0.4 |
| Net real return in % | 8.5 | 5.6 | 1.1 | 4.3 |

For more information on the Fund please see the following links:

Ministry of Finance:
www.regjeringen.no/en/dep/fin

Government Pension Fund:
www.government.no/gpf

Norges Bank Investment Management:
www.nbim.no

Council on Ethics:
www.etikkradet.no

United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic and International Monetary Policy, Trade & Technology
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Testimony of Matthew J. Slaughter for Joint Hearing,
"Foreign Government Investment in the U.S. Economy and Financial Sector"

Wednesday, March 5, 2008 2128 Rayburn House Office Building

Committee Chairman Frank, Congressman Bachus, Subcommittee Chairs Gutierrez and Kanjorski, and fellow members, thank you very much for inviting me to testify on these important and timely issues regarding Sovereign Wealth Funds.

My name is Matt Slaughter, and I am currently Associate Dean and Professor of International Economics at the Tuck School of Business at Dartmouth, Research Associate at the National Bureau of Economic Research, and Senior Fellow at the Council on Foreign Relations. From 2005 to 2007, I also served as a Member on the Council of Economic Advisers, where my international portfolio included Sovereign Wealth Funds and related topics.

Let me start by making three points about the economic benefits of Sovereign Wealth Funds.

First, many Sovereign Wealth Funds were created as legitimate stewards of national economic welfare. Many of today's most prominent Funds hail from countries with surging fiscal revenues from production of oil and other natural resources, and many funds aim to manage these revenues for sound goals such as intergenerational transfers. Here, it is important to remember that the United States itself is home to such Funds; for example, the Alaska Permanent Reserve Fund.

Second, to the extent that Sovereign Wealth Funds invest for commercial motives of high risk-adjusted rates of return, the overall U.S. economy benefits from their investments into the United States. This is true of both foreign direct investment that brings managerial control and portfolio investment that does not. America's commercial and investment banks are a prominent recent example of these gains. Funds' investments provided these world-class companies with much needed capital to stabilize their near-term performance and thereby benefit the overall U.S. economy. The United States has long benefited from open global capital markets, of which these Funds are now an important part.

Third, to date the magnitude of Sovereign investments into the United States remains quite small. At year-end 2006, the rest of the world owned $17.4 trillion of American assets. The recent surge of investments into the United States by Sovereign Funds is large to you and me, but it is still a tiny fraction of American's gross international investment position—a fraction of one percent. Globally, these Funds are estimated to control between $2 and $3 trillion in assets: again, a lot to you and me but only somewhere between one and two percent of the world's tradable securities.

These economic benefits aside, the "S" in Sovereign Wealth Funds presents a legitimate policy concern. Were these funds to operate for non-commercial reasons, they could damage the United States. Some of this damage could be economic, such as poorly run companies aiming at goals other than maximizing shareholder value. But much more importantly, some of this damage could be to national security, were these funds to use their investments in American companies to further their political or strategic interests in conflict with those of the United States.

So, what to do about this legitimate policy concern? Let me answer this question in two parts. First, let me list three important costs to the U.S. economy that we run the risk of incurring should excessive constraints be placed on these Funds in an attempt to address this concern.

First, we could incur economic damage to U.S. companies at home. American companies have historically been strengthened by foreign investment—both controlling and passive stakes, by private and government-related investors alike. A tangible example of this is employment and earnings at insourcing companies. In 2005 there were 5.1 million Americans working for U.S. affiliates of foreign multinational companies, earning an average annual compensation of $66,042—31.8 percent above the average for the rest of the private sector. At a time today when many are rightly concerned about the labor-market fallout of the economic slowdown, these tangible benefits of inward investment to American companies are well worth remembering.

Second, we could incur economic damage to U.S. companies abroad. In a forthcoming Council of Foreign Relations report, David Marchick and I have documented a new protectionist drift in inward-investment policies around the world. In the last two years, at least 11 major countries, which combined received 40.6 percent of all world inflows of foreign direct investment in 2006, passed or debated new laws to restrict or refine rules governing certain types of FDI. In this environment, new U.S. restrictions on inward investment may well be met by similar restrictions against U.S. companies abroad that would harm their competitiveness.

Here, it is very important to remember that U.S. multinationals serve foreign markets mainly by host-country affiliate sales, not by exporting. In 2005, U.S. parents of U.S. multinationals exported $456 billion in goods to foreign markets. But that same year their majority-owned affiliates sold nearly $3 trillion in goods--$6.58 in affiliate sales for every dollar in parent exports.

Third, we could incur economic damage to the overall U.S. economy by raising the risk of a disorderly adjustment to the chronic U.S. current-account deficits of recent decades. In 2006, the U.S. current-account deficit reached a record high of $811.5 billion. The main economic cause of this deficit is low U.S. national savings relative to U.S. national capital investment. To finance the excess of imports over exports of goods and services that underlies these current-account deficits, each year the United States must, on net, sell an equivalent amount of assets to the rest of the world. So, in 2006 the United States needed to sell $811.5 billion worth of U.S. assets to foreign investors.

In current discussions of international economic policy, there is much concern about the future path of the U.S. current-account deficit. The likelihood of a gradual, orderly evolution of the U.S. current-account deficit—and of the value of the U.S. dollar—will be higher the wider is the range of U.S. assets the rest of the world can reasonably purchase and the wider is the range of foreign investors—including Sovereign Wealth Funds.

Let me close my testimony with the second part of my reply to the question, "What to do?" For now, I recommend two strategies.

One is diligent U.S. participation in ongoing multilateral dialogues with Sovereign Wealth Funds to generate more and more-transparent information about their governance, goals, and strategies. Recent interest in these Funds has revealed that for many there are some clear gaps in what we know. Like in so many other areas, here, too, sound public policy is best founded on complete and robust information. With the support of the U.S. Treasury Department and others, the International Monetary Fund has launched a discussion with several Funds to create and follow a set of best practices. These discussions are well underway and should be supported. The resulting increase in quality and quantity of information about Sovereign Funds should help allay many concerns about the likelihood of these Funds operating for non-commercial reasons that could threaten U.S. security.

The second strategy is to urge support by all interested parties in the continued non-political operation of the Committee on Foreign Investment in the United States. Last year's Foreign Investment and National Security Act was the outcome of a robust, bipartisan discussion that aimed to build on the many already-sound CFIUS practices. Today, the reforms of FINSA and its related Executive Order need to be implemented without undue political interference. CFIUS is well suited to address any legitimate national-security concerns raised by U.S. investments by Sovereign Wealth Funds—or, let me remind everyone, by any other foreign investor as well. One important reason for this is that CFIUS does not have any statue of limitations. Any inward transaction can be brought to CFIUS not just before but also after closing, should any concerns arise after the fact. During my time serving on the Council of Economic Advisers, I had the privilege of working on CFIUS first-hand with the sound leadership of colleagues at the Treasury Department and many other government agencies. Let the CFIUS process work.

Let me thank you again for your time and interest in my testimony. I look forward to answering any questions you may have.

Testimony Concerning
Foreign Government Investment in the U.S. Economy
And Financial Sector

Ethiopis Tafara
Director, Office of International Affairs
U.S. Securities and Exchange Commission

Chairman Gutierrez and Chairman Kanjorski, and Ranking Members Paul and Pryce:

Thank you for inviting me to speak before today's joint hearing on the subject of foreign government investment in the U.S. economy and financial sector.

I should state at the outset that, as Chairman Cox, Secretary Paulson, and others have noted on many occasions, the United States welcomes foreign investment. I know that is a view widely shared and supported by members of this Committee as well. You have asked me to speak to the particular issues that arise not from foreign investment, but from foreign government investment in the United States, from the standpoint of the Securities and Exchange Commission. There are some important differences between the two.

A bit of history to begin. As others have noted, government ownership of investment funds and businesses is not new, but the scale on which today's sovereign wealth funds and sovereign businesses are operating is new – as is their remarkable growth over the past few years. Today, sovereign wealth funds hold, by some estimates, more than $2.5 trillion in assets. That is more than all the world's hedge funds combined. And sovereign business is eclipsing in size even the very largest privately owned companies: very recently PetroChina surpassed ExxonMobil as the world's largest company by market value. It is typical of today's publicly held state-owned enterprises in that it has offered just 12% of its shares to the public, according to regulatory filings.

There are important differences between sovereign businesses and sovereign wealth funds, as well. Unlike the case of sovereign wealth funds, whose portfolio investment may be purely passive, a sovereign business is controlled by the government whose assets comprise a majority of its ownership. Any analysis of foreign government investment in the U.S. economy and financial sector, therefore, should include consideration not only of sovereign wealth funds, but also of the equally significant and potentially even more thorny issues surrounding sovereign businesses, whose minority interests are owned in part by U.S. investors, because both trends are manifestations of a serious blurring of the distinction between the role of the market and the role of the state.

What should be of even greater interest than the current status of these forms of state ownership is the projected growth of sovereign ownership in global public markets. It is forecasted by Morgan Stanley, for example, that sovereign wealth funds will increase five-fold by the middle of the next decade. That could make these funds, collectively and perhaps individually, the largest shareholders in many of the world's biggest companies that are today privately owned. At the same time, because of the growth in sovereign business, many more of

the world's biggest public companies could be directly controlled by governments.

The reasons behind the rapid growth of state-controlled investment funds and state controlled businesses are still being debated among academics and policymakers. The superficial reasons are clear enough: rapid economic growth in some developing markets, large trade surpluses with the United States, and rising oil prices have generated U.S. dollar surpluses in East Asia, the Middle East, Norway, and Russia. But the fact of rapid economic growth and the influx of dollars alone does not ameliorate potential concerns regarding the fact that governments, rather than private market actors, have the power to control the investing of this new-found wealth and may not have the same, market-sensitive set of incentives that characterize the private sector.

To note, over the past few decades, many of the command economies of the past have embraced market-based economics, at least in some areas. Greater international trade that has resulted from this liberalization could have been expected to give rise to greater wealth in private hands, and a proliferation of market participants. But instead, in many cases, a chief effect of broader trade has been growth in government-held foreign exchange reserves. Sovereign wealth funds have emerged as a way for governments, rather than individuals and privately owned firms, to invest the foreign exchange that has been generated by expanded trade. The growth in sovereign business may also be attributed, at least in part, to the effects of liberalization in nations which had a very circumscribed private sector in the past. These nations are embracing part of the free enterprise model – securities exchanges and public capital raising – while hanging on to state control.

Sovereign wealth funds consisting of foreign exchange reserves have always tended to invest abroad, since their capital was based on a foreign currency. What is new, in addition to the increase in the amount of their capital, is their emphasis on investing in companies around the world, rather than just investing in foreign government bonds. In this sense, they are now competing with other diversified investment vehicles, including mutual funds, pension funds, and hedge funds in the United States.

Sovereign wealth fund investment in the U.S. capital market – like cross-border investment generally – potentially offers benefits. Through their competition for investments in the United States, sovereign wealth funds can help offer U.S. companies a lower cost of capital and a more liquid market for their securities than might otherwise be available. But those same benefits would likely accrue to U.S. companies and markets if the foreign investment were privately directed, rather than government directed. And so it is necessary to inquire into the special consequences that ensue when it is not just a foreign individual or entity but a foreign sovereign doing the investing – or in the case of sovereign business, a foreign sovereign which is outright owning and controlling companies in the public markets.

A sovereign investor or controlling person behind a business raises a number of potential concerns for regulators and other market participants. Because the fund manager or business owner is a government, it may have different and more complex incentives than those that normally drive private sector marketplace participants to make decisions. Sovereign wealth funds, and sovereign businesses, may therefore have a distorting effect on market. If government-controlled companies and investment funds increasingly direct the investment of

business and capital, what will be the effect on the pricing of assets and the allocation of resources?

The SEC's mandate is focused on investor protection, maintaining fair and orderly markets, and promoting capital formation. Accordingly, the SEC has in place several rules that require disclosure of certain sovereign wealth fund activities and sovereign business activities that could raise many of the concerns we hear in our own and other markets. None of these disclosure requirements was designed with sovereign wealth funds or sovereign businesses in mind, but they are nonetheless of value in this context to the extent that many of the concerns that sovereign investing raises are similar to concerns about other types of investment.

For example, the SEC requires through Form 3 under Section 16(a) of the Securities Exchange Act that an issuer's officers and directors, as well as any beneficial owner holding 10% or more of an issuer's equity securities, disclose their ownership interest. If one of these persons or entities buys or sells securities in the issuer, this change in ownership interest must be disclosed through a Form 4 filing within two business days.

Among other things, this disclosure requirement is designed to provide the market with information about the purchase and sale of issuer securities by individuals and entities who may be in a privileged position with regard to important information about the company. This could include both sovereign wealth funds and governments or government officials who own securities in a public company. Trading on the basis of material non-public information, of course, is prohibited by the Commission's Rule 10b-5 under Section 10(b) of the Exchange Act. Nonetheless, Forms 3 and 4 strengthen the integrity of our markets by providing information about the investments of insiders and large shareholders – including sovereign wealth funds – in the companies they run or may have control over.

Likewise, the SEC requires beneficial owners of 5% or more of an issuer's equity securities to file Form 13-D under Section 13(d) of the Exchange Act. This disclosure must be made within 10 days of the purchase and is designed, among other things, to disclose possible takeover attempts of an issuer. Form 13-D also requires the beneficial owner of the securities to disclose the source and amount of funds being used to purchase the shares, and announce whether the purpose of the purchase is to acquire control as well as any plans or proposals with regard to future actions by the purchaser.

In some cases, investors controlling between 5% and 20% of an issuer, and who do not intend to control or influence control of the issuer, may file Form 13-G instead. This disclosure is often used by institutional investors such as mutual funds and state pension funds, but is also available to sovereign wealth funds that are passive, albeit sizable investors in a public company.

Finally, the SEC requires institutional investment managers who exercise investment discretion over $100 million or more of U.S. exchange-traded equity securities to file a Form 13-F. The form requires a manager to disclose the name of each reportable issuer in the manager's portfolio as of the end of each calendar quarter, as well as the number of shares and the market value. It also provides some information about the manager's voting authority. Entities that may not be registered with the SEC – such as managers of pension funds, endowments, and domestic and offshore hedge funds – often are required to file Form 13-F. The same reporting standard

applies to sovereign wealth funds.

These and other examples make the point that SEC rules that apply to investors in the U.S. capital market also apply to sovereign wealth funds and sovereign businesses. That said, laws and regulations can be rendered meaningless without an effective enforcement mechanism. One of the significant concerns about sovereign wealth funds and sovereign businesses is not that they are foreign, but that their managers are sovereign. While request for cross-border enforcement assistance might be readily honored by a foreign government with respect to private actors in the market, help may not be as forthcoming if the subject of the request is the government itself.

Governments that control sovereign wealth funds and sovereign businesses, because they are governments, can in some cases control certain economic events, and they may have information advantages over private market participants. Governments routinely are privy to certain types of information that most private investors are not. What if the fund obtains information through its status as a government entity?

In addition to questions of market efficiency, transparency, enforcement, and information disparity, sovereign businesses and sovereign wealth funds raise other issues as well. One is the increased opportunity for political corruption. When individuals with government power also possess enormous commercial power and exercise control over large amounts of investable assets, the risk of misuse of those assets, and of their conversion for personal gain, rises markedly.

The SEC is not without tools, however, when it comes to enforcement. If the SEC were to pursue wrongdoing by a sovereign wealth fund or a sovereign business, and the jurisdiction in which it is based did not cooperate in our investigation, our Commission's response would be firm. And even in the face of a lack of cooperation from the country in which the foreign actor is based, we know from experience that market manipulation, insider trading, and other illegal activities that take place in the American market often leave sufficient evidence that the SEC can proceed with an enforcement action against the offender.

Nor does the fact that a fund or a business is owned by a foreign government shield it from liability under U.S. federal securities laws. It is a well-established principle of American jurisprudence and international law that sovereign immunity does not extend to a state's commercial activities in another jurisdiction. And while SEC enforcement cases involving a foreign person or entity are, all things being equal, somewhat more complicated than those with no cross-border nexus, SEC staff have a strong track record investigating such cases and working closely with our foreign counterparts in collecting evidence abroad.

Just this past year, the SEC sent more than 550 requests for assistance to foreign regulators, and we received more than 450 in return. The SEC expects this number to grow, as cross-border securities activity grows, and as it becomes easier for investors to move assets across borders. To cite just one example, this past year, approximately 34% of our insider trading cases brought by the SEC's Division of Enforcement involved the SEC's Office of International Affairs seeking assistance from the SEC's foreign counterparts.

Furthermore, the ability to provide this type of cross-border regulator-to-regulator cooperation in enforcement investigations is now an international expectation. In 2002, in the wake of the attack of September 11, the International Organization of Securities Commissions created the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, which is a multilateral arrangement through which the MOU's signatories agree to share enforcement-related information. Today, this arrangement has 47 signatories, with another 15 publicly committed to obtaining the legislation they need to provide this information to others. Furthermore, in 2005, IOSCO's membership agreed that by 2010 the ability to sign on to this MOU would become a criterion for continued membership in the organization. Most of the governments that have sovereign wealth funds that invest in the United States are members of IOSCO, and many have already signed on to the MOU.

Shared international support for fair and transparent markets is also driving cooperation on the development of best practices for sovereign wealth funds. The International Monetary Fund currently is developing a set of voluntary best practices for sovereign wealth funds. And late last month, the European Commission proposed a common EU approach for a code of conduct for sovereign wealth funds. Although discussions are ongoing, it is contemplated that sovereign wealth funds would disclose such things as:

- The investment positions and asset allocations, particularly where they have majority ownership
- The exercise of ownership rights
- The use of leverage
- The size and source of their resources, and
- A disclosure of their home country's regulation and oversight that governs the sovereign wealth fund.

These international developments are encouraging. The United States is already ahead of the curve on this subject – in our country, these disclosures are already mandatory for any sovereign wealth funds of significant size.

Finally, if we were to prohibit sovereign wealth funds from investing in our market for fear they might introduce market distortions, there is a risk we might actually end up doing precisely this ourselves through the prohibition. A better approach might be to address the underlying issues of transparency, independent regulation, de-politicizing of investment decisions, and conflicts of interest.

I hope this brief overview of the issues surrounding foreign government investment in the U.S. economy and financial sector from the perspective of the Securities and Exchange Commission is helpful to you. I will be happy to answer your questions.



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